
Assessment of GS \$Mart:

Department of General Services'
Program for Financing Acquisitions
of Equipment and Other Goods



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F E B R U A R Y 2 0 0 3

“But the fine legal distinctions between leases and debt are not material to the financial considerations that should discipline governmental leasing practices. In face of competing demands for their limited general fund resources, government agencies can afford only so many long-term lease obligations ... Moreover, agencies should subject leasing decisions to central planning and control procedures, to prevent the unplanned accumulation of lease obligations, which are fixed commitments that diminish needed budgetary flexibility.”

California Debt and Investment Advisory Commission,
Guidelines for Leases and Certificates of Participation, 1993 (page 9)

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Executive Summary

The GS \$Mart program enables State departments to lease-purchase essential items of equipment and other goods (personal property). The program is designed to meet the standard requirements of municipal lease financing, which ensure that the loans are not considered State debt and satisfy tax-exemption, securities disclosure, and contract validity concerns.

Since its inception in 1996, 327 loans totaling \$434 million have been approved. Also, at least 7 loans totaling \$63 million have been undertaken by departments that did not utilize the GS \$Mart program. Two-thirds of the GS \$Mart loans are for less than \$500,000 and for less than 4 years. The vast majority of the loans are simple loans for equipment. The heaviest users of the program are the State's data centers. Half of the loans have been repaid, and the annual amount of repayments that must be made on the outstanding loans is about \$65 million.

The legislative authority for the program is derived from the Department of General Services' (DGS) broad procurement authority and implied by references, but it is not explicit or coherent. There appears to be some ambiguity regarding the role of the State Treasurer in program oversight.

The financing contract reflects the requirements of municipal lease financing, and provides broad authority to the lender. The program has attracted a large number of well-qualified lenders who offer competitive loan interest rates. Efforts are made to educate departments about the risks and obligations of the program. The process is streamlined, and the DGS provides considerable assistance to departments. The program has emphasized customer service to State departments and the lenders, who view the program very favorably. However, more attention needs to be paid to oversight, accountability, and protecting the State's interests.

There are three fundamental State interests in the program: (1) protecting the State's credit rating; (2) protecting budgetary flexibility; and (3) assuring continued access to high-quality personal property loans. In assessing the program in terms of these interests, six guiding principles were employed: adhere to the highest standards of municipal lease financing; preserve efficiencies of the current program; allocate responsibility consistent with accountability; be conservative; institute checks and balances; and establish clear and consistent legal and operational framework.

The GS \$Mart program should be continued since it provides a necessary means for departments to pay for essential equipment over multiple fiscal years, but current loan risks should be mitigated. Legislation should be enacted to establish a clear structure for personal property financing that clarifies the goals for the program as well as requirements for the DGS, Department of Finance, the State Treasurer, State departments, and lenders. Loans outside the program should be prohibited, unless the State department has its own credit rating. The State Treasurer's Office should determine which loans are higher risk and process those loans. Risky and inappropriate assets should not be financed. Loans should be approved through the budgetary process, and the appropriations to repay the loans should be identified in budget documents. Financial reporting to the State Controller and the Bureau of State Audits must be improved.

Implementing these recommendations should reduce the risks of the program and strengthen the assurance to lenders of the State's willingness to repay the loans. We also recommend that minor additional requirements be imposed on lenders. It is not possible to predict the lenders' reactions to these proposals, but it is hoped that they would not reduce their participation in the program or increase their rates.

Summary of Recommendations

Debt and Credit Issues

- State Treasurer's Office should screen all loan requests
- Assignment, securitization, and placement provisions need to be strengthened
 - Private placement language should be unambiguous
 - Traveling sophisticated investor letter should be required
 - DGS should receive notice of all assignments
 - Notification should be required for securitization
 - Local agency approval of securitization must be required
 - Assignees should be financially qualified
- Loans and repayment schedules must be part of the budget process
 - Augmentation requests should specifically indicate financing costs
 - All financings should be approved in advance by Finance
 - Budget should specify amounts needed for loan repayments via supplementary schedules
 - Large, unscheduled baseline-funded financings should be reported to the Legislature
 - Finance staff need appropriate training
 - Finance should establish a centralized resource unit for lease-purchasing issues
- Risky and inappropriate assets should not be financed
 - System integration projects
 - Software
 - Real property projects
- Financial reporting must be improved

Legal Framework

- Statutory authorization needed, with clear structure and guidance
- Respective roles of DGS, Finance, and the State Treasurer should be clarified
- Loans outside the GS \$Mart program put the State at risk and should be prohibited
- Two existing statutory provisions should be deleted
 - Bids for acquisition and financing should be fully separated
 - Telecommunications services should not be financed
- Nonsubstitution clause should be eliminated

Due Diligence

- Procurement concerns
 - Procurement authority needs better documentation
 - Evidence of proper bidding needs documentation
- Loan process concerns
 - Fund source needs to be taken into account
 - Essential need for asset needs better documentation
 - Program should follow its own rules
 - Lenders should be evaluated
 - Lowest cost lender should be required for all asset types
 - Treatment of small business lenders should be clarified
 - Training and certification of departmental personnel should be instituted
 - Alpha Plan certification form should be signed by the lender
- Contract concerns
 - Alpha Plan contract should be signed
 - Clarification of “lender” needed
 - Administrative cost language should be updated
 - State benefits from escrow account should be in contract
- Legal oversight and review needs strengthening
 - Changes to standard contracts should be identified for review
 - Consistency between procurement and financing contract/closing documents should be rigorously checked
 - Opinion of Counsel should be required on all contracts
 - Opinion of Counsel should be stronger

SECTION ONE

Background and Purpose of Study

The Golden State Financial Marketplace — aka “GS \$Mart”¹ — is a program operated by the DGS through which State and local agencies may quickly obtain competitively priced financing for installment purchases, also known as lease-purchases. The GS \$Mart program is not a financing program, but acts as a financial clearinghouse providing potential State and local borrowers with vendor and loan interest rate information for financing the purchase of goods. Under GS \$Mart, lenders are pre-qualified by DGS and agree to a standard financing contract. The lenders post their rates on the Internet, allowing participating agencies to select their choice of lender based on price. Financing deals may be concluded within a few days and entirely via electronic communication.

Nearly all the financing under the GS \$Mart program is tax-exempt. Tax-exempt leasing, also known as municipal lease financing, is commonly used by a variety of governmental programs across the nation to finance acquisitions ranging from simple equipment to large facilities. The GS \$Mart program was developed to help State departments finance personal property, i.e., items other than real property. The GS \$Mart program has been recognized by several procurement and information technology professional associations for its innovation and efficiency.²

Questions about the program arose during analysis of the Oracle computer contract, which DGS financed through GS \$Mart with a \$52.3 million loan over a 7-year period. When it appeared that the Legislature might not be willing to appropriate the funds to repay the loan, State officials were advised that financial markets would consider nonpayment a default that would reflect upon the credit rating of the State as a whole and the market for State debt. A downgrading of the State’s credit rating and an adverse market reaction would have resulted in increased borrowing costs for general obligation (GO) bonds, lease-revenue bonds, energy efficiency bonds, etc. The program’s potential impact on the capital market

¹ Pronounced “G-S Smart.”

² For example, GS \$Mart is designated a best practice in lease-purchasing by the National Association of State Procurement Officials, and in 1998 it received the best administrative applications award from the National Association of State Chief Information Officers.

was unexpected and created an interest in learning how the GS \$Mart program operates, and what might be done to improve financial safeguards for the program. The following report describes the GS \$Mart program, discusses key issues, and recommends numerous changes to help protect the State's interests.

Note: The GS \$Mart is one of several programs utilized by the State to finance acquisitions or improvements or otherwise pay for property usage over time; some of these other programs may also warrant review for adequacy of fiscal safeguards. Statewide programs administered by the Public Works Board that involve the State Treasurer include lease-revenue bonds for capital outlay projects and energy efficiency bonds. Statewide programs administered by the DGS that do not involve the State Treasurer's Office are the Lease \$Mart program, the Master Rental Agreement, Lease-To-Own-Purchase program for copiers, and the Real Estate Services Division acquisitions program (e.g., for real property, modular buildings, etc.). The University of California and California State University have their own financing programs. In addition, departments may solicit financing or accept lease-purchase financings proposed by vendors, e.g., the Legislative Data Center and Caltrans. Finally, departments with long-term facilities leases may pay for tenant improvements through their leases.

SECTION TWO

Municipal Lease Financing

Municipal lease financing is a tool used by state and local governments across the nation to finance acquisitions over time. Municipal lease financing offers budgetary and accounting advantages, as well as debt management advantages depending upon the jurisdiction's respective constitutional or statutory provisions. In assessing GS \$Mart, it is important to understand why State departments finance acquisitions rather than purchase them outright. It is also important to understand how municipal leases are structured to avoid debt, remain tax-exempt, and meet securities requirements.

Financing versus Purchase

Departments acquire needed capital assets by purchase (taking ownership) or rental (not taking ownership). A lease-purchase agreement, which is the vehicle used in municipal lease financing, is a hybrid arrangement in which ownership is acquired and payments are made over time. There are several reasons why State departments finance acquisitions instead of purchasing them outright.

Constrained resources — Lease-purchasing is used for items that the department cannot afford to pay for all at once. The department may not have sufficient baseline funds to replace essential equipment that suddenly fails. Or, an augmentation request was denied for fiscal reasons, such as General Fund constraints, or a special fund department has an insufficient fund balance to pay for an expensive item in one year.

Level budgeting — By spreading out payments over time, lease financing enables a department to maintain a stable budget across several fiscal years. Such stability is highly advantageous for departments reliant upon fee-based services, such as the data centers or special fund departments.

No reserves — Private entities often establish reserves for capital improvement or replenishment, or reserves for equipment replacement. (Such reserves are defined as “sinking funds” in accounting parlance.) State departments, however, are not budgeted

with reserves or contingency funds. While reserves or contingencies do not appear to be illegal, they are not traditionally accepted for policy reasons.

Federal accounting requirements — In addition, State departments that allocate costs back to federally funded programs must maintain no more than 60 days of working capital, or else pay the federal government back for excess reserves.³ This requirement applies to departments funded from internal service funds, such as the DGS and the State's data centers. There have been several instances in prior years when the data centers and DGS have had to repay the federal government for excess reserves, which amounted to about \$16 million in one year.⁴

Other accounting benefits (payments related to use) — By paying for an item over its useful life, a department is paying only for what it actually uses in any given fiscal year.

Municipal Leasing is Not Debt

The State Constitution (Article XVI, Section 1) prohibits debt unless it is approved by two-thirds of the Legislature and ratified by a majority vote of the people, i.e., GO bonds. Case law recognizes several exceptions to the constitutional limit, including the long-term lease with rental abatement⁵ and the nonappropriation doctrine, both of which are used in municipal leasing. Under the rental abatement exception, which underpins the State's lease-revenue bonds, the obligation is considered a contingent expense rather than debt, because a scheduled payment does not have to be made if the public does not have beneficial use of the leased facility. Under the nonappropriation doctrine, which underpins the GS \$Mart program and the State's energy efficiency bonds, the obligations are not considered debt, because a loan does not have to be repaid if the Legislature does not appropriate the funds within the fiscal year in which the payment on the loan is due. The nonappropriation doctrine has a long tradition of use both at the state and local government levels in California and is widely accepted nationwide.⁶

³ Office of Management and Budget Circular A-87, Attachment C, Section G.2

⁴ Interview with Wanda Kelley, Fiscal Services and Consulting Unit, Department of Finance, October 7, 2002.

⁵ Also known as the Offner-Dean Doctrine, after two 1942 and 1950 Supreme Court decisions.

⁶ New Jersey is reconsidering this issue. In a case decided by the Supreme Court of New Jersey in August 2002, the court considered whether there was a difference between debt that the State was legally obligated to pay and debt that the State was morally obligated to pay, and whether "contractual" or appropriation debt violated the State's constitutional limitation on debt. The chief justice noted that the negative impact on a State's credit rating from failure to appropriate a loan repayment ensures that the legislative body will make the payments. The chief justice further requested that briefs on this issue be scheduled for hearing in Fall 2002. It should be emphasized that the view that "appropriation debt" violates the State constitution was held by a single justice on the court. Steven M. Lonegan; Stop the Debt.com. LLC v. State of New Jersey (A-23-01)

Because municipal leases are not considered debt, they are not backed by the full faith and credit of the State and are riskier for investors. Various provisions have become standard in municipal lease contracts to help ensure that the obligation is not deemed debt, and to compensate for the resulting increased risk to the lender.⁷ In state government personal property leases, these provisions include the following:

Nonappropriation clause — Provides that the scheduled payment does not have to be made if the Legislature does not appropriate funds for the fiscal year in which the payment is due. (Of all the standard provisions, this is the only one designed to prevent a determination of debt.)

Covenants to seek appropriation — Requires the state government entity to request an appropriation from the Legislature.

Investor security interest — Although title is passed to the state government entity, the investor is granted a lien, or “security interest” in the asset, so that the asset can be repossessed if there is no appropriation.

Nonsubstitution clause — In the event of nonappropriation, the government department is prohibited from replacing the asset with a similar asset for a specified period of time. Many lawyers question the enforceability of this provision, which has not been well-tested in the courts, so the provision is usually qualified as being in force to the extent permitted by law, or to the extent that the validity of the lease is not adversely affected.

Essential use certificate — The state government entity certifies that the item being financed is essential to the provisions of government services. “Essentiality” is a critical factor for lending agencies, because it implies that the department will do whatever is necessary to repay the loan.

Acceptance certificate — The department certifies that the purchased item is satisfactory and has been accepted for use.

Insurance premiums — Lenders typically require the state government entity to insure tangible assets. An intangible asset, such as software, may not require insurance.

⁷ Association for Governmental Leasing & Finance, *An Introduction to Municipal Lease Financing: Answers to Frequently Asked Questions*, July 2000.

Federal Tax Considerations

In general, items leased by municipal governments may be financed on a tax-exempt basis. However, there are numerous federal requirements that must be met to achieve and maintain tax-exemption. The most common and relevant requirements are as follows:

Eligible entity — Tax-exempt debt can only be issued by a governmental entity that has the power to tax, power of eminent domain, or police power.

Useful life — An item may not be financed for a period longer than 120 percent of its useful life.

Capital expenditures only — The financed item must be a capital asset.⁸ With respect to information technology (IT), hardware is clearly allowable; maintenance or consulting not related to an asset is not allowable; and there is a gray area for services that are provided only with software and not sold separately (e.g., customization, first-year prepaid maintenance).

Arbitrage — Usually the lender pays the supplier immediately for the item. However, if the supplier is being paid over time (such as in a phased equipment installation, or a custom computer application that is being developed), the lender must set aside the entire amount up front, which is deposited into an “escrow” or “acquisition” account. If the lender invests the funds for a greater return than is being charged as interest to the state government entity, the lender may have to pay an “arbitrage rebate” to the federal government.

Registration — The Internal Revenue Code requires that tax-exempt municipal leases be registered with the federal government in order for the income to be tax-exempt, and that ownership be tracked.

Assignment and securitization — Federal rules limit the amount of tax-exempt debt that private lenders may hold.⁹ For this reason, lenders frequently assign (i.e., sell) the lease repayments to another investor or financing company. The original lender may continue to receive the payments from the state government entity, or the assignee may assume this function. Securitization is a form of assignment in which the lender or assignee converts the loan (i.e., the debt service revenue stream of payments) to another financial vehicle (e.g., a trust or certificates of participation) in which interests may be sold to one or more parties, who are often paid a lower interest rate than the yield of the original loan.

⁸ There are exceptions for small amounts of working capital.

⁹ No more than 2 percent of corporate assets.

Private Activity — If private activity associated with the lease exceeds specified levels, the financing is not tax-exempt. To stay within the specified levels, any proceeds of the loan spent on private activity cannot exceed 10 percent of the total, and any repayments of the loan from private sources of funds cannot exceed 10 percent of the total.

Securities Considerations

Although municipal leases are not generally considered securities by the Securities and Exchange Commission (SEC), those that are *publicly offered* are subject to anti-fraud disclosure requirements, which include a detailed review by lawyers, underwriters, rating agencies, financial advisors and others, and result in a massive document often several inches thick. Disclosure is not required for “*private placements*,” which are sold to a maximum of 35 “sophisticated investors” (i.e., parties sufficiently knowledgeable to conduct their own review of risks, such as financial institutions and high wealth individuals) in denominations of at least \$100,000. This SEC rule on disclosure (Rule 15c2-12) applies to securities of \$1 million or more. Disclosure typically costs at least \$100,000, which is added to the financing cost, and is not financially practical for loans smaller than \$5 million. Thus, small leases typically are placed privately.

Contractual Considerations

It is fundamental to the validity of a municipal lease that the procurement upon which the lease is based be properly authorized and executed within the rules and regulations of the state government. Also, lenders typically want an assurance that the financing contract is valid and binding. The state government is not obligated to make repayments on an illegal contract.

TABLE 1

**How the GS \$Mart Program Meets
Municipal Lease Needs and Requirements**

Municipal Lease Needs and Requirements	GS \$Mart Program Elements (Alpha Plan Contract Provisions, Closing Documents, Other Processes)
Non-Debt Protections	
Nonappropriation clause	Provision I
Covenant to seek appropriation	Provision II
Investor security interest	Provision VII-C, Uniform Commercial Code form UCC-1, Program eligibility criteria
Nonsubstitution clause	Provision II
Essential use	Alpha Plan Certification, Program eligibility criteria
Acceptance	Alpha Plan Certification
Insurance	Provision XI-D, Alpha Plan Certification
Federal Tax Exemption Requirements	
Eligible entity	Provision III, Opinion of Counsel
Useful life	Program eligibility criteria
Capital expenditures only	Program eligibility criteria
Arbitrage	Provisions IX-A and IX-C, Alpha Plan Certification, Tax Certification
Assignment	Provisions VII-A and VIII
Registration	Provision X-A, Alpha Plan Certification, IRS Form 8038G (or 8038GC)
Private activity	Provision IX-C
All of the above	Bond counsel opinion
Securities Requirements	
Disclosure	Provisions IX-D and X-C, Alpha Plan Certification
General Contract Requirements	
Validity of procurement	Certificate of Compliance, Purchase Order, Other documents
Validity of contract	Opinion of Counsel, Certificate of Compliance

SECTION THREE

History and Use of GS \$Mart

Origin

According to the DGS, State departments have engaged in installment purchases since the late 1970s. Prior to the GS \$Mart program, the vendor would include financing as part of a bid, which generally involved an agreement with a lending company. Several months would elapse between the time the financing rate was proposed and the time the procurement and lending agreement were completed, which created a price risk for financing agents that was reflected in higher rates. Furthermore, according to DGS staff, only three lending companies provided financing to bidders on State procurement contracts, and one company provided about 80 percent of the financing; thus, there was no incentive to provide competitive rates.

In the mid-1990s, the DGS and other departments became concerned that the State was paying too much for such financing. After meeting with the DGS and the Department of Finance (Finance), the State Treasurer's Office (STO) commissioned a feasibility study, which determined that existing leases could be pooled and refinanced at a lower rate (through certificates of participation).¹⁰ However, this refinancing did not occur. The STO staff indicated such a program would be very complicated to administer due to the different types of assets, terms, and departments involved. Although documentation from this time period is minimal, according to the DGS, the STO and Finance did not want to be involved in administering a new program. The STO's lack of interest appears to have been based in part on an impression that DGS loans are for small amounts.

In Spring 1996, determined to reduce financing costs, the DGS initiated the Golden State Financial Marketplace, to be known as "GS \$Mart." The GS \$Mart is a financial clearinghouse that provides prospective state and local government borrowers with information

¹⁰ Bear Stearns, *State of California, Master Lease Refinancing Program*, December 21, 1992.

about loan interest rates being offered by various lenders for financing the acquisition of equipment and other similar goods. The lenders are pre-qualified by DGS and agree to a standard financing contract. All program information, including lenders' rates, is provided on the Internet (on the DGS website), and financing deals can be concluded in a few days and entirely via electronic communication.

Use of GS \$Mart by State agencies is voluntary. Financing outside of GS \$Mart would have to be procured as any other acquisition. Since the inception of GS \$Mart, the DGS has assisted in at least seven personal property acquisition loans that did not utilize the GS \$Mart program. In many cases, the supplier included the financing in the bid, or required the use of the supplier's captive lender.

Current Administration

GS \$Mart is administered primarily by three staff members, including two GS \$Mart managers, in the Program Support Section of the Procurement Division. According to the DGS' budget office, the 2002-03 budget for the GS \$Mart section is \$298,500. In addition, one attorney from the DGS' Office of Legal Services (OLS) is involved in reviewing documents and issuing the Opinion of Counsel. Staff from the Acquisitions Section of the Procurement Division are involved on an as needed basis if the GS \$Mart managers have concerns regarding the procurement. The DGS' administrative costs for GS \$Mart are funded by the acquisition service fee (currently 1.93 percent of procured amounts).

Data and Statistics

The DGS data file used in this analysis was originally developed for the Governor's Task Force on Contracting and Procurement Reform. The DGS updated the file for this analysis and added additional fields, including information on what was purchased. It must be noted that numerous errors were found in the data, and no guarantee of accuracy is provided. However, the file is sufficiently representative for the purposes of this analysis.

Number and Dollar Volume of Loans

Since its inception in 1996 through August 2002, a total of 327 procurements have been financed through GS \$Mart, totaling \$458 million.¹¹ In addition, from 1996 through 1999, the DGS provided assistance on 7 other loans totaling \$63 million that were not processed through the GS \$Mart program.

¹¹ These figures include the \$52.3 million Oracle contract in 2000-01, which has since been rescinded.

The amount financed ranged from \$10,000 to \$52 million. Over half the loans were between \$100,000 and \$499,999, and 67 percent were under \$500,000. Until about two years ago, the DGS recommended a minimum financing amount of \$100,000, because lenders generally are not interested in small loan amounts and the interest rates are relatively higher. At the request of State departments, the DGS lowered the recommended minimum to \$50,000. About 5 percent of the loans are under \$50,000.

Contract Term

GS \$Mart contracts ranged from 13 months to 10 years. Over half — 55 percent — of the loans were for 3-3.75 years, and 67 percent were for less than 4 years. Most of the terms seem reasonable, based on the information available on the type of equipment, price, and useful life. For example, one of the 10-year loans was for a \$5 million airplane, and one was for a \$9.7 million printing press with a 20-year useful life. These both seem reasonable based on the long life of the acquisition. For at least one contract, however, the term raises questions, i.e., a five-year loan for personal computers. DGS had informed us that all personal computer loans could not exceed three years, yet it proceeded with a longer period of financing in this instance.

TABLE 2
Number of Loans and Amount Financed by Year

Fiscal Year of Purchase Order	Number of Loans	Dollars
1995-96	3	\$937,625
1996-97	45	\$60,916,094
1997-98	70	\$100,833,993
1998-99	55	\$62,458,582
1999-00	56	\$63,937,187
2000-01	59	\$125,079,009
2001-02	38	\$43,220,270
2002-03 partial year	1	\$621,554
Total	327	\$458,004,315

TABLE 3
Number of Loans by Amount Financed

Amount Financed	Number of Loans	Percent
\$10,000,000 or More	9	3%
\$5,000,000 to \$9,999,999	10	3%
\$1,000,000 to \$4,999,999	41	12%
\$500,000 to \$999,999	49	15%
\$100,000 to \$499,999	173	53%
\$50,000 to \$99,999	28	9%
Under \$50,000	17	5%
Total	327	100%

TABLE 4
Number of Loans by Contract Term

Term of Contract	Number of Loans	Percent
10 years	4	1%
7 years	5	1%
5 to 5.5 years	63	19%
4 to 4.5 years	37	11%
3 to 3.75 years	178	54%
2 to 2.75 years	37	11%
13 to 20 months	3	1%
Total	327	100%

User Departments

The GS \$Mart program is most heavily used by the data centers. The Health and Human Services Agency Data Center financed 80 acquisitions; the Teale Data Center financed 42; and the Franchise Tax Board financed 20. Other significant users of GS \$Mart financing are the Departments of Rehabilitation (22), General Services (20), Transportation (18), Corrections (14), and Social Services (13). Most departments have financed only one or two acquisitions. The Department of Justice financed 7 projects under GS \$Mart and another 5 outside of GS \$Mart.

Significant use by the data centers and DGS is consistent with the fact that those departments are funded by internal service funds that allocate costs back to federally funded programs. As noted earlier, the federal government prohibits such funds from maintaining more than 60 days of working capital. It is therefore difficult for them to accumulate sufficient reserves to purchase expensive equipment outright.

TABLE 5

Number of Loans by Department

Number of Loans	Number of Departments	Department Name
80	1	Health and Human Services Agency Data Center
42	1	Teale Data Center
18-22	4	Rehabilitation, Franchise Tax Board, General Services, Transportation
13-14	2	Corrections, Social Services
5-9	6	Education, Justice, Controller, Finance, Consumer Affairs, Developmental Services
3-4	7	Mental Health, Employment Development, Industrial Relations, Board of Equalization, Toxics, Health Services, Youth Authority
1-2	27	Various
Total	48	

Program Eligibility Criteria and What's Been Financed

The GS \$Mart eligibility criteria are designed to meet the municipal leasing requirements described earlier. Four criteria have been established:

1. The item being financed must be essential to the State department.
2. The financing term cannot exceed the useful life of the asset being financed.¹²
3. The item must be personal property, and not real property (so that the lender can repossess it in case of default or nonappropriation).

¹² *California Acquisition Manual, Section 3.1.6 (Draft), Provisions C.4 and C.5, 1999.* Federal rules allow tax-exempt financing to extend to 120 percent of the useful life, but such a long term is not advantageous to either the lender or the State department.

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4. The asset must consist of goods (either IT or non-IT goods), but IT services may be included in the financing if they are part of a purchase of IT goods (e.g., installation, training, software customization). Contracts that are over 50 percent services are considered services contracts, and are not eligible for GS \$Mart financing.

The vast majority of the GS \$Mart financings appears to have been simple equipment acquisitions, which easily meet the criteria for personal property and tangible goods. Of the 327 purchases financed, 305 (94 percent) were for equipment. These purchases include IT equipment (65 percent), business-related equipment (24 percent), vehicles (2 percent), and miscellaneous equipment (3 percent). Miscellaneous equipment included a prefabricated building, a lawnmower, generators, and modular furniture/cubicle panels.

Some of the financings have been for software (4 percent), which is not a tangible asset. About 1 percent of the financings have been for IT system integration projects. (System integration projects are those in which a contractor builds an IT system using hardware and software from different suppliers, and typically provides extensive software customization and development.) These projects usually have a sizable services component for software development, and a long implementation period. Another 1 percent of the financings have been for cabling within buildings or lighting — real property projects that do not meet the criterion for personal property.

The following table shows the distribution of GS \$Mart loans by category. It must be noted that many of the purchases, particularly the larger ones, include a variety of items, and the categorization may not be completely accurate. Note that all system integration projects may not have been identified, in part because there is no clear definition of what “system integration” means.

TABLE 6

Number of Loans by Type of Assets

Type of Asset	Number of Loans		Dollar Amount	
	Number	Percent	Dollars	Percent
IT Equipment	211	65%	\$177,413,885	39%
Other Business Equipment	77	24%	\$56,210,177	12%
<i>Telecommunications and Videoconferencing Equipment</i>	(36)	(11%)	(\$35,000,439)	(8%)
<i>Photocopy and Production Publishing Equipment</i>	(23)	(7%)	(\$5,300,469)	(1%)
<i>Mailing, Scientific/Medical, and Industrial Equipment</i>	(18)	(6%)	(\$15,909,270)	(3%)
IT Software	14	4%	\$74,015,857	16%
Miscellaneous Equipment	9	3%	\$15,228,092	3%
Vehicles (includes one airplane)	8	2%	\$16,339,178	4%
IT System Integration Projects	5	1%	\$100,691,202	22%
Real Property Projects	3	1%	\$18,105,923	4%
Total	327	100%	\$458,004,315	100%

Outstanding Balances

As of July 1, 2002, nearly half the GS \$Mart loans (161 out of 327) have been fully repaid. For the remaining loans, \$153 million is outstanding, with estimated annual loan repayments of \$65 million.¹³

TABLE 7

Number of Loans and Amounts
Borrowed and Owed by Status of Loan

Status of Loan	Number of Loans	Percent of Loans	Amount Borrowed	Amount Owed	Estimated Annual Payment
Paid in Full	161	49%	\$203,558,616	\$0	N/A
Balance Remains	166	51%	\$254,445,699	\$153,359,705	\$64,704,012

¹³ Annualized payments for loans that had an outstanding balance as of July 1, 2002. Some of these loans may since have been paid off.

SECTION FOUR

Legal Framework

No Specific Statutory Authorization

There is no specific authority for the GS \$Mart program. The DGS states that the authority is implied in Government Code Section 14615, which gives DGS general authority over financial and business matters within its jurisdiction, and in the sections of the Public Contract Code noted below. In general, these statutory provisions do not provide the DGS explicit and coherent authority to finance acquisitions:

- **Section 10320.5** specifies the timing of interest computations on installment purchases, and thus indirectly authorizes installment purchases.
- **Section 12100** provides a separate authority for IT procurements, by or under the supervision of the DGS.
- **Section 12101.5** expresses legislative intent that State agencies “use an acquisition method that is compatible with their short- and long-term fiscal needs”, and further states that “[t]here is a need for ... long-term contracts with annual cancellation and fund-out clauses ... ” This section also authorizes multiple awards, master agreements, and use of the federal General Services Administration Multiple Awards Schedules (i.e., the California Multiple Award Schedules, aka CMAS).
- **Section 12102(e)** requires the State to evaluate financing proposals from suppliers not less than 30 days before the bid deadline, unless the State department can justify to the DGS why the proposal should not be considered.
- **Section 12113(b)** specifically authorizes State agencies to “enter into financing agreements for the acquisition of *telecommunications services* [emphasis added] whenever

the state ... may derive monetary benefit and greater services as the result of its ability to acquire capital at a lower interest cost” than provided directly by the supplier, or if a long-term agreement results in a lower cost of services.

- **Section 12120** provides that all telecommunications acquisitions shall be made by or under the supervision of the DGS, and in accordance with the rules regarding IT. The section also provides the DGS broad authority for policies and procedures for telecommunications and IT acquisitions.

Just as there is no specific authority for the GS \$Mart program, there is also no specific authority for departments to engage in personal property financing outside the GS \$Mart program. The authority is implied in the Public Contract Code sections cited above.

Unclear Role of State Treasurer

Government Code Sections 5700 and 5702 designate the State Treasurer as the sole agent for offering and selling bonds or other evidences of indebtedness. “Evidence of indebtedness” is further defined as *“includes, but is not limited to [emphasis added], certificates of participation or interests in any rental or lease payments or installment purchase payments, in an aggregate principal amount exceeding \$10,000,000, to be made by the state or any state department, board, agency, or authority with respect to buildings or other capital improvements.”*

The view of the STO chief counsel is that the phrase “includes, but is not limited to” applies only to the types of debt instruments listed, and that these sections give the State Treasurer’s Office authority to sell bonds for real property only. However, it can be argued that the phrase “includes, but is not limited to” applies to: (1) the types of debt instruments listed; (2) the \$10 million threshold level; (3) the application to real property; or (4) all of the above. Thus, in this view, the State Treasurer has broader responsibilities for acting as sole agent than it currently exercises.

The practice that has evolved over time is that the DGS informs the STO of GS \$Mart loans that exceed \$10 million. The DGS’ staff indicates that notification occurs before the financing deal is finalized. The STO staff indicates that notification is after the fact and does not always occur.

SECTION FIVE

Financing Contract

GS \$Mart contract provisions have been designed to avoid the creation of constitutional debt as well as meet tax exemption, securities, and contractual considerations. GS \$Mart offers two standardized contracts: the Alpha Plan for tax-exempt financing, and the Beta Plan for taxable financing. The Beta Plan is rarely used¹⁴ and is not addressed further in this report.¹⁵ Participants in tax-exempt leases are required to use the Alpha Plan, and the GS \$Mart website indicates that the standard terms and conditions are always used, “except for special cases where the contract needs to be enhanced for particular assets, such as, but not limited to, software or aircraft.”¹⁶ From a State oversight perspective, the following Alpha Plan provisions are most significant:

Definition of Contract and Parties

The Alpha Plan defines the contract as the Alpha Plan and the payment schedule, as well as the Certification Form and other closing documents that are discussed in Section VI (see Alpha Plan Purpose of Agreement). The contract is with *the State*, not an individual department, because individual departments are not eligible to issue tax-exempt debt under federal law. An Opinion of Counsel is used to certify that the individual executing the contract has the authority to commit the State to the contract (see Alpha Plan Provision III).

¹⁴ The Beta Plan would be appropriate if the acquisition under the following circumstances: (1) federal funds — it may not be clear that the acquisition is to be owned by the State and therefore eligible for tax-exempt financing; (2) private activity — an item for which a private party receives more than 10 percent of the benefits is deemed “private activity”, and the financing is not tax-exempt; (3) the lender did not want tax-exempt interest. DGS indicates that the Beta Plan was used only twice by State agencies, in both cases because the loans had zero interest, and thus there was no interest to exempt from taxation.

¹⁵ The Beta Plan is the same, except that it lacks the provisions required for tax exemption.

¹⁶ Under General Information, Lender Qualifications, in the section titled “Qualifications Proposals.”

No Advance Payments

The participating department is not obliged to make any payments, including interest, prior to accepting the goods (Purpose of Agreement). For a contract with an extended implementation period, such as a phased equipment installation or system integration project with software development, the project is broken into several deliverables, each of which must be accepted before payment for that component is obligated. For such projects, the lender is authorized to establish an escrow account in which the entire payment amount is set aside until needed (Provision VII-A). The DGS requires that interest accruing to the account be credited to the State's repayment obligation, although there is no provision in the contract or other legal requirement governing this credit.

Termination

The participating department may terminate the contract for nonappropriation of funds by the Legislature. If there is no specific appropriation, the "remaining general funds of the State are not reasonably expected to be used" to make payments (Provision I). In the event of nonappropriation, the lender has the right to reclaim the asset. Unlike standard DGS procurement contracts, the participating department may not terminate its financing contract for convenience (Provision IV-B) except if the goods have not been accepted. If the goods have been accepted but the supplier has not been paid, the GS \$Mart staff believe the lender would probably be agreeable to termination, although this condition is not explicitly allowed under the contract. In any other case, even if the State department terminates the procurement contract, it is still liable for the financing contract.

No Prepayment Penalty

While the terms of long-term tax-exempt bond issues often prohibit prepayment for 10 years, prepayment is allowed for GS \$Mart loans (Provision IV-A) and is encouraged by the DGS to reduce overall borrowing costs.¹⁷ Prepayment penalties are seen as desirable by lenders, particularly for large loans, because they are a disincentive to prepayment; enable the lender to recover the administrative costs if the loan is paid off early; and permit the lender to more easily assign and securitize a loan since the stream of repayments over time is more certain to continue. For these reasons, lenders typically offer a lower interest rate if there is a prepayment penalty.

¹⁷ GS \$Mart website, Financing/Refinancing Plans and Rates, Helpful Hints and Information, Hint 2.

Nonsubstitution of Assets

In the event of nonappropriation, the State is prohibited from obtaining similar assets for one year, to the extent permitted by law (Provision II).

Assignment and Securitization

The lender has broad authority to assign the loan as well as all the lender's rights and responsibilities. Approval of the State is required if the assignee becomes the "paying agent" (i.e., assumes the function of billing and receiving payments from the State). If the assignee does not become the paying agent, only notification is necessary. If the lender assigns the loan to an entity (e.g., a trust) that issues proportional interests (i.e., sells shares) in the loan to an unspecified number of investors, no approval is necessary (because there is no change in paying agent), but notification is required (Provisions VII-A and VIII).

Private Placement

The contract indicates that GS \$Mart loans are intended to be placed privately, but leaves open the possibility of public sales. The contract indicates that the lender and assignees are financially knowledgeable and able to bear the risk of the investment, which is indicative of private placement (Provision X-C). The contract indicates that the State is not selling any securities, and the lender is not allowed to make any statements to the contrary (Provision IX-D). The State is not required to provide any disclosure information necessary for public placement of any assignment (Provision VII-A). However, the contract states that the lender must request in writing any "actions" it desires from the State with respect to securities laws (i.e., disclosure information for public offerings), which implies that public offerings may be permitted, although the contract indicates that the State does not guarantee that it will agree to such a request (Provision IX-D). Also, the Alpha Plan indicates that the Certification Form may include an agreement under which the State would provide disclosure information (Provision IX-D). (Note: The Certification Form is a closing document that is discussed in Section VI, GS \$Mart Loan Process.)

Example: The Oracle Contract

The Oracle contract provides a useful example of how some of these contractual features worked. The Oracle contract, at \$52.3 million, was the largest by far of any GS \$Mart loan. Because the loan was so large, the financing company, Koch Financial Corporation (Koch), needed to assign and securitize the loan (to stay within federal limits on tax-exempt holdings), and needed the assistance of other lenders to place the loan. Koch was permitted by the assignment provisions of the GS \$Mart program to bring in other firms to help market the loan. In order to attract other lenders, Koch needed to ensure that the stream of payments from the State would continue, so Koch negotiated with the DGS to amend the standard contract by eliminating the prepayment option. Koch created two private placement trusts (\$10 million and \$42.3 million, respectively), and sold a substantial share in one of them to Merrill Lynch. Merrill Lynch provided a credit enhancement (a letter of credit, which guaranteed loan repayment) that allowed the trusts to receive a “AA” credit rating. Within the trust structure, a variable rate money market product was created and sold to major California money market funds, such as the Franklin Templeton Fund.

Thus, the money market investment vehicle established under the trust and initially secured from the GS \$Mart loan reached the public market, but the GS \$Mart loan itself remained privately placed. If funds for repayment of the GS \$Mart loan had not been appropriated, Koch and Merrill Lynch would not have received loan repayments from the State, but the investors in the money market fund would not have been affected because the Merrill Lynch credit enhancement provided debt security, and the money market fund would have been repaid by Merrill Lynch. Although the two trusts had been created by a pledge of DGS annual debt service, Koch and Merrill Lynch were the only parties that had direct recourse to the GS \$Mart program to seek repayment of the loan.

SECTION SIX

GS \$Mart Loan Process

Qualification of Lenders

The GS \$Mart program requires that lenders meet qualifications for financial soundness in order to be eligible for the program. The initial qualifications proposal has 17 requirements, including audited financial statements, certifications that the firm has not been sanctioned by the State or federal government, certification regarding any State or federal investigations during the past 20 years, evidence of good financial rating from Dunn and Bradstreet, and customer references. Lenders also agree to confidentiality. Lenders must requalify every two years, using an abbreviated process if they have been active lenders in the GS \$Mart program, and using the original process if they have been inactive.

There are two types of lenders in the program: lenders willing to finance any type of asset, and lenders who are willing to finance only the assets made by a particular company (i.e., “captive lenders”). Captive lenders are not allowed to post rates on the website, but are allowed to offer financing proposals. In Fall 2002, there were nine qualified captive lenders.

Posting of Lenders’ Rates

Once qualified, the lenders are able to post a sample of their rates weekly to the GS \$Mart website. If they do not post for three weeks, they are removed from the website. Sample rates are posted for five financed amounts: \$50,000, \$100,000, \$250,000, \$500,000 and \$1 million. For each financed amount, rates are posted for five terms: 24 months, 36 months, 48 months, 60 months, and 84 months. The table below provides an example of the rates posted on a recent day for a \$250,000 loan, and comparison to a benchmark indicator of market rates for municipal issues with similar risk. (Note: Normally there are more than nine lenders qualified to post rates, but seven lenders were temporarily suspended pending completion of the biennial requalification process.)

TABLE 8

Rates for a \$250,000 Loan on October 23, 2002

Term of Loan	Number of Lenders	Range: All Lenders (Lowest to Highest Rate)	Range: 5 Lowest Lenders (Lowest to Highest Rate)	Basis Point Spread: 5 Lowest Lenders	California Baa/BBB Revenue Tax Exempt Rate ¹⁸
24 months	8	3.000% - 5.900%	3.000% - 3.550%	55	2.57
36 months	9	3.320% - 5.950%	3.320% - 3.630%	31	3.04
48 months	9	3.550% - 5.980%	3.550% - 3.690%	14	3.41
60 months	9	3.700% - 5.980%	3.700% - 3.790%	9	3.72
84 months	9	3.983% - 6.140%	3.983% - 4.180%	20	4.32

The rates at the high end of the range for all lenders are clearly not competitive. According to GS \$Mart staff, the lenders with these rates are not actively participating in the program but want to remain qualified and visible. The active participants post their rates at the low end.¹⁹

The posted rates are “based upon delivery of asset within 30 days of the rate quote, no acceptance testing period, quick acceptance, payment to supplier within 30 days after acceptance, and first payment made by agency 30 days after acceptance.”²⁰ These conditions describe a simple equipment purchase with no complicating factors, which is known in the industry as a “plain vanilla deal.” On plain vanilla deals, the posted rate is the maximum that the lender is allowed to charge, and lenders typically bid *below* their posted rates on such deals. Since all the lenders can view posted rates on the website, the lenders know how much further they must reduce their rates to beat the competition. Plain vanilla deals comprise about 90 percent of all GS \$Mart loans.

If there are complicating factors, lenders are allowed to bid higher rates. Such factors include an intangible asset, phased implementation and acceptance, and a long period of time before the supplier or lender is paid. A typical variance for complicating factors is about 10-20 basis points. The variance on the Oracle contract was 100 basis points, which was the most for any GS \$Mart contract, and was primarily because the first payment to the lender was 16 months after acceptance and the asset was software (i.e., intangible).

¹⁸ Municipal Market Data (MMD), October 22, 2002. MMD is a key source of information about the municipal bond market. According to Tom Dunphy of Lamont Financial Services, the most appropriate benchmark for interest rates on appropriation risk debt is a full grade below the State’s rating for general obligation bonds. For the time of this table, the rating that is a full grade below the general obligation bond rating is the Baa/BBB revenue tax-exempt rate. (Personal communication, October 23, 2002).

¹⁹ According to the DGS, it conducted a study which indicated that prior to the establishment of the GS \$Mart program, State departments were paying interest rates that averaged about 134 percent of comparable-term US Treasury rates, whereas under GS \$Mart, State departments are paying about 82 percent of comparable-term US Treasury rates. The DGS states that based on these figures, the program has saved the State \$50 million in financing costs since its inception. Unfortunately, the DGS has not been able to provide a copy of the study. Furthermore, US Treasury rates are not the most appropriate benchmark, since they sometimes move in the opposite direction of financing rates, so it is not possible to determine if the study is meaningful.

²⁰ See the website page for Alpha Plan (Tax-Exempt) and Rates, under the heading “Current Rates.”

Departmental Education and Consultation

The GS \$Mart program reported that when a department first inquires about GS \$Mart loans, the GS \$Mart manager works with departments to educate their staff about the advantages and disadvantages of financing, and the necessity to repay the loans. According to the GS \$Mart manager, the budget officer or a budget analyst must be present, and departments are always told that purchasing is less costly than financing. The GS \$Mart website includes additional information to assist departments in understanding the process. The GS \$Mart staff also help a department determine if its procurement is eligible for financing under the program's guidelines (some loan requests have been denied as ineligible).

Steps in the Process

The GS \$Mart financing process has the following six steps, which are depicted in the flowchart in Figure 1 at the end of this section and further described below. It is important to bear in mind that State departments have two means of repaying GS \$Mart loans: either they have sufficient funds in their baseline budget, or they require an augmentation through the budgetary process. If an augmentation is required, it should have been approved before the department completes the procurement.

- 1. Procurement.** The State department (or the DGS on behalf of the department) conducts a procurement, consistent with applicable statutes, regulations, and rules. If the State department conducts the procurement under its delegated authority,²¹ the GS \$Mart program verifies the department's delegation status online (the list of current delegation holders is maintained on the DGS website) or with other procurement staff.

The State department may use a standard procurement contract; the primary ones are the CMAS contract and the standard IT contract. Less frequently used are the standard commodities contract and the Master Rental Agreement. When the department uses a standard contract, such as the CMAS, the purchase order (PO) is considered to be the "contract" — the PO includes a reference number for the standard contract rather than a printed copy of the contract terms and conditions.
- 2. Selection of Lender.** Per DGS' draft procedures (California Acquisition Manual [CAM], Section 3.1.6), the State department identifies prospective lenders from the GS \$Mart website, and requests financing quotes by submitting a Rate Quote form. Specific quotes

²¹ At the time this report was written, most departments had requested and received the "base" delegation for goods, which allows them to purchase up to \$25,000 of non-IT goods without involving the DGS. About 40 departments had requested and received the base delegation for IT, which allows them purchase up to \$500,000 of IT goods without involving the DGS.

are necessary because rates for individual acquisitions may vary from the posted rates, primarily based on the nature of the asset (e.g., a straight commodity purchase has less risk than a multi-year IT project), but also because the specific amount, term, and payment schedule might vary from the assumptions on which the posted rates are based. The draft procedures suggest that agencies request at least three quotes, preferably from those lenders with the lowest rates. The form can be submitted electronically (via fax or e-mail). The lenders return the Rate Quote forms to the department.

In practice, agencies usually request the DGS to help them obtain the rate quotes. Further, in September 2002, DGS adopted a new process under which the GS \$Mart manager now completes and submits the Rate Quote form. The DGS reports that the GS \$Mart manager routinely selects the lenders with the five lowest posted rates, as well as any qualified small business lenders (currently there is only one) and the supplier's captive lender, if there is one (as a courtesy to the supplier).

The rate quotes must include a payment schedule that separately identifies interest and principal (required for federal tax-exemption). The DGS validates each lender's proposed payment schedule with the interest rate that the lender claims to be charging. In some cases, the payment schedule includes costs that are in addition to the interest rate indicated, which is a violation of program rules. The DGS issues warnings to lenders who add costs and has removed two lenders from the program for continued violation of this rule.

The State department selects the lender. The DGS requires the department to select the lender with the lowest bid if the asset is a non-IT commodity. For IT goods and services, the department is allowed to select the lender that provides "best value." GS \$Mart staff explained that the decision rules for the financing parallel the decision rules for the asset procurement ("lowest bid" for non-IT goods and "best value" for IT goods and services).

After selecting the lender, the department issues the PO to the supplier. The PO must incorporate information about the financing, including the name and address to which payments are sent, specific reference to the Alpha Plan, and the payment schedule (with both interest and principal). The department sends copies of the PO to the lender, the GS \$Mart manager, the State Controller's Office, and the department's accounting and budget offices.

3. Delivery and Acceptance. The supplier delivers the goods, and the department accepts them. Acceptance periods vary, depending on the nature of the goods. A complex acquisition may have multiple deliverables and therefore multiple acceptances.

4. Closing Documents. There are four to six closing documents, depending on the loan and/or the lender.

- **Alpha Plan Certification Form.** The certification form serves the following purposes: (1) certifies acceptance of goods; (2) provides insurance information; (3) certifies that the assets are essential and that the need is not temporary; also describes the purpose for which the assets will be used; (4) indicates the date that the obligation begins (same as date of acceptance); (5) requires the lender to maintain records of assignments to fulfill IRS requirements; (6) requires the lender to meet federal arbitrage requirements; (7) provides the name and address used by the State Controller to make the payments; and (8) indicates that the State will not provide any continuing information that would be required for disclosure on a public issuance. This eighth provision is an optional provision, since the Alpha Plan contract indicates that the Certification Form *may* include an agreement regarding the State's provision of continuing disclosure information. The lender prepares the form but does not sign it; the department signs the form and returns the original to the lender; the department sends a copy to the GS \$Mart manager.
- **Uniform Commercial Code form.** This form provides the lender with a security interest in the asset. The lender prepares the form; the department signs and returns it to the lender; the lender files the form with the Secretary of State.²²
- **Certificate of Compliance.** On this form, the department director (or designee) certifies that the procurement was authorized and conducted properly. The DGS' OLS uses this form as documentation for the Opinion of Counsel. The department prepares and sends the forms to the GS \$Mart manager.
- **Opinion of Counsel.** This form certifies that the GS \$Mart loan agreement is valid and binding, and fully authorized. All lenders except one require the form. The department requests the opinion from the GS \$Mart manager, the GS \$Mart manager prepares it, and DGS' OLS signs it. The GS \$Mart manager sends the original to the lender.
- **Tax Certification.** This form is used for the more complex deals when a bond counsel opinion is obtained, although one lender requested its use for all deals. If there is an escrow account, the form indicates how the escrow account will be funded and

²² This practice is customary in the municipal leasing industry, but is not required under California statutes.

disbursed. The lender prepares and signs the form, and sends it to the State department; the State department signs the form and returns it to the lender.

- **Bond Counsel Opinion.** The GS \$Mart manager requests an opinion from bond counsel on complex financing contracts, e.g., those that involve system integration, escrow accounts, large dollar volumes (\$10 million or more), or anything unusual. The bond counsel provides the GS \$Mart program with an opinion on compliance with federal tax-exemption requirements.²³ Because of the cost of the bond counsel opinion, it is not practical to obtain one for financings less than \$5 million.

5. Payments to Lender. After the participating department has accepted the assets, the lender pays the supplier for the equipment, and the State Controller pays the lender per the loan repayment schedule from funds appropriated to the participating department. For an IT project with multiple acceptances, loan repayments are only made on the items that have been accepted.

6. Internal Revenue Service (IRS) Reporting. The IRS must be notified of all tax-exempt financing. The lender prepares IRS form 8038-G (\$100,000 or more) or 8038-GC (less than \$100,000), then sends the form to the GS \$Mart manager. After the supplier has been paid and the loan commences, the GS \$Mart manager verifies the information, signs the form and sends it to the IRS.

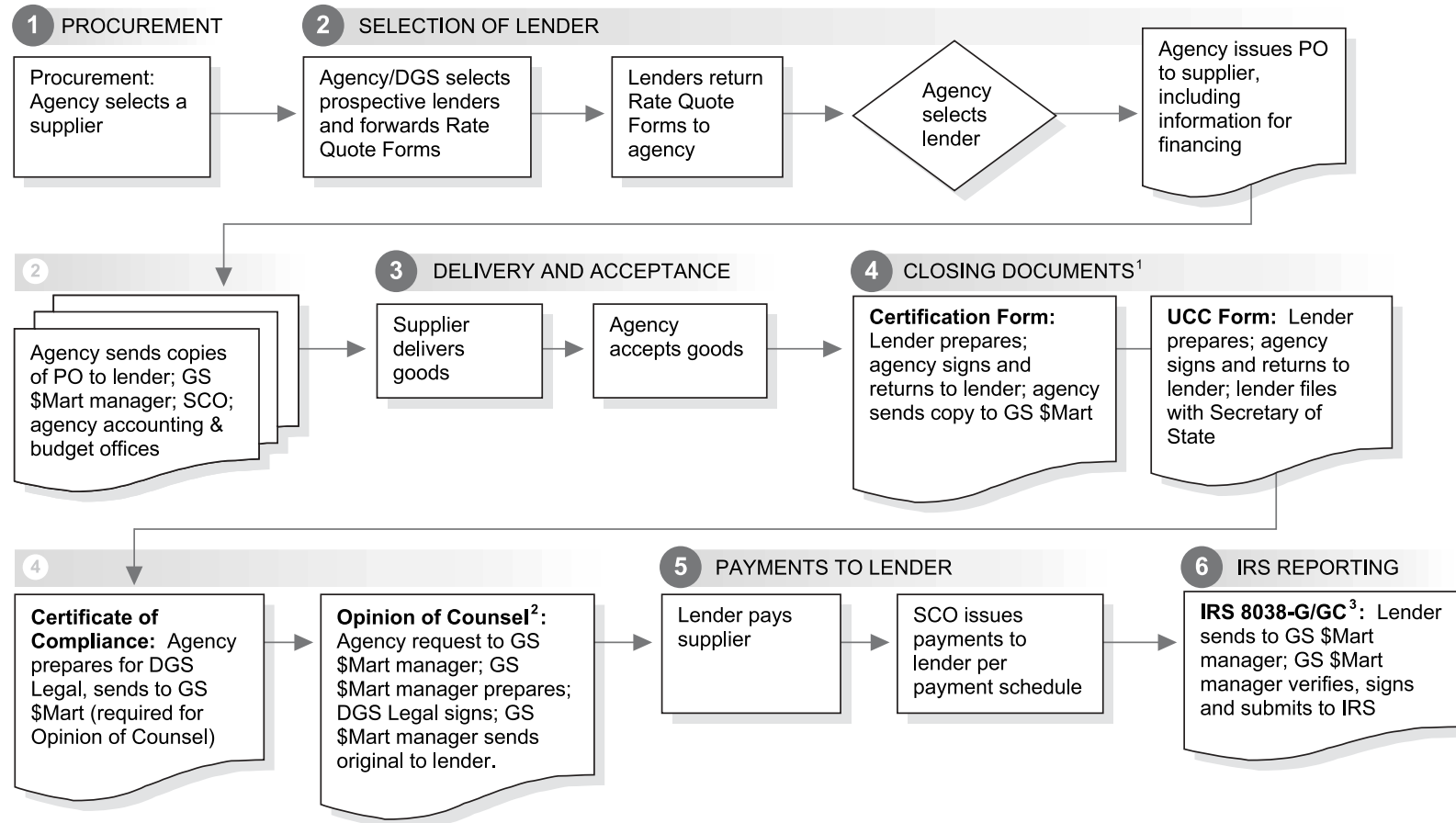
Variations on the Process

The order of the steps listed above might vary for individual projects; for example, sometimes preliminary rate quotes, or “financing estimates,” are obtained before the procurement is complete. Also, the administration of the program has been changing over the past few months, and some practices are being altered to improve oversight and accountability. The DGS has drafted a new Certificate of Compliance form, which the DGS may shift to the beginning of the process to serve as a request for GS \$Mart financing that must be approved before the rate quotes or financing estimates can be requested. However, if the State department is requesting financing estimates before the procurement is complete, some of the elements on the Certificate of Compliance form will not be known. Therefore, the GS \$Mart may develop another process for requesting financing estimates.

²³ For publicly issued debt, bond counsel provides a contract validity opinion as well as a tax opinion. For the GS \$Mart program, the contract validity opinion is not provided.

FIGURE 1

Flowchart of the GS \$Mart Loan Process



¹ Two additional closing documents may be required for complex loans: Tax Certification and Bond Counsel Opinion.

² Opinion of Counsel is required by all lenders except one.

³ IRS 8038-G/GC filings—8038-Gs (\$100,000 and up) are filed quarterly with the IRS, and must be filed 45 days after the quarter in which the lender pays the supplier for the assets. 8038-GCs (\$99,999 and less) are held and the filed with the IRS in the first quarter of each calendar year (February 15th).

SECTION SEVEN

Assessment and Recommendations

The GS \$Mart program has been administered with an emphasis on customer service to the State departments and the lenders. In this area, the program has been successful — it is very popular with State departments and lenders, who find the program efficient and user friendly. The program has paid less attention to oversight and accountability or to protection of the State’s financial interests. To its credit, the DGS has recognized this in recent months and has begun to institute changes. Some changes have been postponed pending completion of this report. This section of the report attempts to define the interests of the State and provide recommendations for better protecting those interests.

The State has three fundamental interests with respect to the GS \$Mart program:

- 1. Protection of the State’s credit rating** — The State’s credit rating and capital market standing could be directly threatened by nonpayment of a GS \$Mart loan, if the financial market deems that nonpayment as a default. Therefore it is important to limit the risk of a nonappropriation by taking reasonable precautions to ensure that the Legislature will support the financing obligation. It is also important to limit the potential consequences of a nonappropriation, should that happen for any reason.
- 2. Protection of budgetary flexibility** — Debt restricts departments’ ability to reallocate resources to respond to unforeseen expenditure needs. Debt also limits the State’s ability to enact necessary budgetary reductions in a time of fiscal constraints. Therefore, all forms of debt, including programs like GS \$Mart, need to be managed within prudent limits.
- 3. Continued access to high-quality personal property loans** — Departments can better manage within existing resources when given the ability to finance equipment over multiple fiscal years. Central service departments, such as the data centers,

that are not allowed to accumulate working capital under federal accounting restrictions, actually require this ability to fulfill their functions. A program that helps ensure lower borrowing costs, such as GS \$Mart, provides an important service, once financing is determined to be the best option, provided that its operations:

- (a) are consistent with the requirements of tax-exempt municipal financing;
- (b) promote open competition and low interest rates; (c) and provide adequate protections for the lender (which help insure low interest rates) as well as the State.

To some extent these interests are competing, and must be balanced. For example, certain safeguards that are instituted to protect the State's credit rating may reduce departments' access to affordable, high-quality loans because interest rates may increase and lenders may leave the program. Also, the more departments finance expensive items to cope with limited fiscal resources, the less budgetary flexibility they will have in future years.

To gain a perspective on these issues, programs in three other states were examined (see Appendix). Each of these states has tried to protect its credit rating by incorporating safeguards into its program that are absent from the GS \$Mart program. While not every program has every restriction, the restrictions include: limitations on size of loan, limitation on type of assets that may be financed, pre-approval by the budgetary authority, inclusion of lease payments in the budget act, restrictions on assignment, and State approval of contracts outside the program.

The three fundamental interests of the State cut across numerous aspects of program eligibility, the legal framework, the program's contract, and the loan process described earlier. To bring some order to the assessment of the program, the issues are grouped into the following areas:

- A. Debt and credit issues** — This section will focus on larger issues from a policy perspective.
- B. Legal framework** — This section will focus primarily on the statutory structure of the program.
- C. Due diligence** — This section will focus on operational issues and procedures.

To address these three areas in terms of the State’s fundamental interests, the following guiding principles were employed:

Guiding Principles

- Adhere to highest standards of municipal lease financing.
- Preserve efficiencies of current program.
- Allocate responsibility consistent with accountability.
- Be conservative — when in doubt, don’t.
- Institute checks and balances: verification and validation, accountability for all participants, appropriate oversight and monitoring, etc.
- Establish clear and consistent legal and operational framework.

A. Debt and Credit Issues

Nonappropriation clause does not protect the State’s credit from willingness to pay concerns

As noted in Section II, the nonappropriation doctrine holds that a loan is not debt if the repayments are subject to annual appropriation by the legislative body. Although many courts have held that the State’s right to non-appropriate is absolute in “appropriation debt,” the consequences of nonappropriation are so severe as to render this right meaningless. It is clear that nonappropriation could result in a downgrading of a State’s overall credit rating. Such downgrading occurred for local governments in both Florida and Washington after nonpayments on appropriation debt.²⁴ While it may not seem logical that nonpayment of appropriation debt should affect the credit rating on general obligation debt, which is backed by the full faith and credit of the State, it is nevertheless the case that rating agencies are concerned with the State’s *willingness to pay*, regardless of the reason or the type of loan. Thus, although the State might have argued that the Oracle contract was inherently a flawed transaction, opinions expressed publicly by some legislators that the

²⁴ Personal communication with Richard Hiscocks, attorney at law of Orrick, Herrington and Sutcliffe, LLP, and Tom Dunphy, financial advisor of Lamont Financial Services, October 29, 2002.

State should not repay the loan concerned the rating agencies. Lenders are also concerned with willingness to pay, and the lenders interviewed for this study indicated that if the State did not appropriate funds to repay a single GS \$Mart loan for any reason, they would cease to participate in the program.

Large loans create additional risk, but no clear threshold amount

The credit risk resulting from nonpayment is greater with larger loans. Based on a conversation with one rating agency, rating agencies would be concerned over any nonappropriation regardless of amount; however, they are less likely to change their ratings over a small amount — there would have to be nonpayment on several small loans, or one large loan. The size of the loan would be important in itself, because it would reflect a lack of willingness to pay a significant debt. In addition, the larger GS \$Mart loans are more likely to be securitized in a manner that reaches the public market, which means that even if the public investors were not at risk, the negative public perception would be worse than if the loan were not securitized. Finally, the larger loans are more likely to involve financial institutions which are also involved with the State's publicly issued debt, and if these institutions were affected by nonappropriation, they might be less likely to underwrite the State's public debt or charge higher fees.

However, there is no clear threshold amount for what is considered large and/or likely to be securitized to the public market. The rating agency interviewed for this study indicated that \$10 million would definitely be a concern, but \$5 million could also cause concern, and that loans of even \$1 million to \$2 million might be pooled in a manner that reaches the public market. Koch, which is a very large company, indicated that it pools and securitizes obligations of \$5 million to \$15 million with other California obligations. Smaller lenders, which would have less access to capital, could be expected to pool smaller amounts to sell to larger institutions.

State Treasurer's Office should screen all loan requests

The STO is responsible for managing the State's debt and its credit rating, and for this reason there was a consensus among the people interviewed for this study (including staff in the STO) that the State Treasurer should be involved in "large" lease purchase agreements. However, given there is no clear threshold amount for "large" loans, we recommend that the

STO review all requests for financing, and identify those that appear to pose a greater risk to the State's credit rating. Low-risk loans (which are the vast majority) could then be referred to the DGS for continued processing. Loans that the STO deems higher risk either should be denied, or should be processed through the STO, which would provide extensive scrutiny that would reduce the security and credit risk to the State and might result in lower interest rates. The STO should have the option of selling lease-secured investments in the public market, if the STO deems that appropriate. There are a variety of policy and implementation issues that would have to be considered to implement this change, which would need to be discussed further with the State Treasurer's Office. Some of these issues are discussed under "Legal Framework," below.

Assignment, securitization, and placement provisions need to be strengthened

There are many ways in which lending companies and financial institutions can securitize municipal leases. Portions of the "undivided interests" (i.e., the payment stream for both principal and interest) in the lease can be sold directly (e.g., certificates of participation), or the lease can be pooled with other leases into a new vehicle that offers similar portions of undivided interests to investors. Securitized municipal leases can be placed publicly or privately. Nonappropriation or default on a securitized State lease that is sold in the open market would have greater adverse consequences to the State than if the securitized lease remained privately held, because there would be more people affected, more publicity, more political concern, and probably more effect on the State's credit rating.

In the 1980s and early 1990s, lenders were able to securitize and sell interests in a governmental lease to the public (certificates of participation) without the knowledge of the governmental entity. This situation created numerous problems. For example, in 1991, Los Angeles County attempted to market a \$28 million equipment lease, but had difficulty doing so because of a \$1.7 million securitized county equipment lease on the market with a significantly higher interest rate.²⁵ This problem in Los Angeles County led to enactment of a State law that prohibits the securitization of *local* government leases without the approval of the local government entity, and imposes fines of up to \$10 million and five years in jail for violation (Government Code Sections 5951 and 5954). In addition, the Government Finance Officers Association in 1993 adopted a recommended practice that government entities centralize all information about leases and clearly establish with the lenders what is permissible with regards to securitization.

²⁵ California Debt and Investment Advisory Commission, *Guidelines for Leases and Certificates of Participation*, 1993, page 31.

In 1996, the SEC enacted the disclosure rule (15c2-12) described in Section II, which imposed additional responsibilities on lenders in order to reduce the securitization risks to governmental entities. Under this rule, a lender cannot sell interests in a governmental lease directly to the public unless the government entity provides the disclosure information; therefore the governmental entity would be fully knowledgeable of the lender's potential plans. If a lender wanted to sell to the public without the governmental entity's involvement, the lender would have to provide a credit enhancement (guarantee) under which the liability for repayment would rest with the lender, not the governmental entity. In the event of nonappropriation, the lender would repay the investors, but there would likely be a negative public perception.

Assignment and securitization provide significant benefits to the borrower. The borrower has better access to capital, because the lenders are able to finance additional loans. Lenders generally offer lower interest rates if they can securitize the loan, because they are able to make income from the sale of the lease or from the spread between the interest rates on the original loan and the new securitized vehicle. Assignment and securitization can also protect the State department in the event of lender bankruptcy — if the loan has been assigned, the lender's creditors cannot repossess the financed assets.

Because of securitization risks, the State should know what leases it holds, and when any securitized leases have reached the open market. Since assignees typically do not participate in the State's contract documents, the further the loan moves from the original parties, the less direct ability the State has to protect its interests. Thus, the contractual provisions regarding assignment, securitization, and placement should be very clear. As noted in Section V, Financing Contract, the Alpha Plan assignment and securitization provisions provide broad authority to the lender, and the placement provisions are ambiguous.

Private placement language should be unambiguous — The Alpha Plan language should be modified to remove any ambiguity about private placement of the loan and any shares in the loan, in order to prevent public offerings, which are too risky and costly. Language should be deleted that implies the State might be willing to provide the disclosure information required for public offering and that indicates an agreement could be included under which the State would provide continuing disclosure information (Provision IX-D), because public offerings are too risky and costly.

Traveling sophisticated investor letter should be required — A sophisticated investor letter is issued by the lender to assure the borrower that the loan constitutes a private placement. Private placements are characterized by assurances to the borrower

that: (1) the lender is sophisticated and knowledgeable about the type of loan; (2) the lender is able to assume the risk involved in making the loan; and (3) the lender has received all of the information it needs to make the loan and is not requiring additional information from the investor. A “traveling” sophisticated investor letter requires that *each successive assignee* certify that it also constitutes a private placement. Given the broad authority for assignment in the GS \$Mart program, a traveling sophisticated investor letter seems prudent, because it would provide continuing assurance that the loan is privately placed regardless of assignment.

DGS should receive notice of all assignments — The DGS’ approval of assignment is required only if the assignee becomes the “paying agent”, i.e., assumes the function of billing the State and receiving payments. If the assignee does not become the paying agent, the lender is required to notify the participating department, but not DGS. The DGS should be notified of all assignments, so that the State knows who is holding its leases. This knowledge is useful for the State to be able to assess its standing in the financial market.

Notification should be required for securitization — The State should also be notified of any securitization that results from an assignment, to better enable the State to know the extent to which the GS \$Mart loans have reached the public market. This knowledge is important, because it enables the State to better assess its standing in the financial market. For example, in the Oracle contract, the State knew that the contract was assigned to a trust, which would typically be used to issue interests to other parties. However, the State did not know that the other party was Merrill Lynch, which is a major investor in the State’s public debt, nor that California money market funds participated in a trust secured by the Oracle loan.

Local agency approval of securitization must be required — DGS uses the State Alpha Plan provisions for local agencies that utilize GS \$Mart financing. As noted in an earlier section, State law requires that local agencies approve any securitization of their leases, and violation of this law is subject to penalties of up to \$10 million and five years in jail. The Alpha Plan is inconsistent with this law, because it states that no notification or approval is required for the lender to securitize local agency loans. This provision must be amended for local agency contracts to require advance approval of securitization.

Assignees should be financially qualified — An assignee typically replaces the lender as the financing agent — that is, the assignment typically occurs at the front end of the loan process and the assignee pays the supplier. Therefore, the financial qualifications of the assignee are as important as those of the lender. The GS \$Mart program requires lenders to meet standards of financial soundness in order to participate in the program. The same requirements should be extended to assignees. The GS \$Mart program should pre-qualify lending companies and financial institutions eligible to receive assignments.

Loans and repayment schedules must be part of the budget process

In order for the Legislature to protect the State's credit rating by appropriating funds to repay GS \$Mart loans, the Legislature and Finance need to know about and approve GS \$Mart loans. A major weakness of the GS \$Mart program is that there is no coordination with the budget process. In consequence, the DGS and the lenders have no evidence that departments can repay their loans, and the Administration and Legislature have no knowledge of departments' long-term fiscal obligations. Absent this knowledge, the risk is greater that the Administration or Legislature may overlook or disavow a repayment responsibility.

In the past, the GS \$Mart program assumed that departments had the ability to repay the loans and did not ask for documentation. The revised Certificate of Compliance will have a box for the department's budget officer to certify that the department has sufficient funds to repay the loan. In our opinion, while an improvement, this certification is not sufficient. Departments do not always have sufficient information about the State's overall fiscal situation to project their next budget, and their interest in acquiring the asset may color their views about their own budgets. The GS \$Mart staff do not have sufficient knowledge or experience about the fiscal situation of the departments to evaluate any information they might be given by the departments. The GS \$Mart program does not collect fund source information, and would not know which special funds might have volatile revenue sources.

Department of Finance expertise is needed to project, to the extent possible, if the department's budget is going to be stable or undergo reductions. Finance should determine the level of expenditures for new long-term commitments that a department or fund source can afford, in order to protect the State from too many long-term commitments. In addition, after the long-term commitments have been made, Finance needs to know how much

has been committed to loan repayments so that it can help ensure that the budgetary resources are provided for departments to make their repayments.

To date, Finance has not played a role in the operation of the GS \$Mart program. Since Finance does not routinely review or approve contracts, the most likely time for it to be informed of a GS \$Mart loan is when a department requests additional funds to make an acquisition. However, departments are not required to report whether or not financing is involved, so under current procedures there is no assurance Finance staff would know when budget requests involve financed purchases. Many Finance staff assume that if a proposal is to be paid for over several years, then each year's payment is for an individual procurement which is separate and independent from the previous procurement, rather than a single procurement with a stream of payments over multiple fiscal years. Moreover, most Finance staff would not be aware of the fiscal issues involved with financing. Finance staff have typically been trained to make sure that a multi-year contract is conditioned on annual appropriations, so that there is no obligation of funds beyond the current year. The Alpha Plan provisions appear to be conditional due to the nonappropriation clause, and thus appear to meet that criterion. Some Finance staff have been aware that a GS \$Mart loan is involved, but assumed that since the program is operated by DGS, there is nothing to be concerned about. If an item were being paid for by funds within a department's base budget, the acquisition would not come to Finance's attention at all. The lack of knowledge puts the State at risk of inadvertent nonappropriation, as illustrated by the example below of the California Postsecondary Education Commission.

Example: The California Postsecondary Education Commission

The California Postsecondary Education Commission is a small department that for many years struggled when it had to meet unexpected expenditures of as little as \$25,000. In August 2001, it financed a four-year loan of \$247,000 for a production publisher from its baseline funds for operating expenses and equipment. A few months later, the May Revision for 2002-03 proposed to reduce the department's state operations budget by 72 percent, leaving only \$328,000 in total for operating expenses and equipment. The Department of Finance and the Legislature were unaware of the financing. The Legislature did not accept the reduction proposal.

The most effective evidence of the State's ability to repay the loans would be specific approval by Finance and the Legislature. The approval mechanisms need to account for the timelines of the budgetary process. Mechanisms would need to be different for loans that require augmentations versus loans funded from baseline budgets.

Augmentation requests should specifically indicate financing costs — Departments currently may or may not provide information on financing in their budget change proposals (BCPs). When they do, it may not be with enough emphasis or detail to attract the attention of Finance staff and the Legislature. The BCP format should be amended to provide a specific section for identifying if assets are proposed for financing, and if so, the financing assumptions, payment schedule, and interest costs. Putting this information in BCPs would ensure that Finance and the Legislature are fully informed about GS \$Mart loans and will include the appropriations in the budget.

All financings should be approved in advance by Finance — The GS \$Mart program should require written authorization from Finance before allowing a State department to initiate the loan process, so that Finance can provide oversight of the State's long-term commitments and ensure that new loans are included in the budget. (Such authorization is required in other states with similar programs, as described in the Appendix.) Authorization should be required for loans funded from baseline budget funds as well as loans funded from augmentations. While such authorization might seem redundant for financings funded from new augmentations included in the budget act, the volatility of the State budget is such that the assets might not be procured until several months after the budget was enacted, and the department might have incurred a budgetary reduction in the meantime, such as occurred in fiscal year 2001-02 in the November Revision. Also, the cost of the asset or the cost of financing could have changed. Thus, it is prudent to revisit the authorization for the financing at the actual time of the financing. An approval form would provide evidence to the lenders that the repayments are included the budget.

Budget should specify amounts needed for loan repayments via supplementary schedules — Currently, the annual budget act contains information about how much is appropriated for loan repayments for lease-revenue bonds and energy efficiency bonds. GS \$Mart loan obligations should be identified in the budget documents so that Finance and the Legislature can protect the State's credit rating by including the amounts in the budget. At minimum, the total amount for loan repayments should be identified as an element in the supplementary schedule for operating expenses and

equipment, and a new supplementary schedule should be developed that provides detail on each individual loan repayment (similar to the supplementary schedule for equipment). The supplementary schedules should include any proposed new financings. After this information has been collected, Finance can assess the advantages and disadvantages of including loan repayment information in the budget act. Because budget act language would function as a limit on payments, and because departments are able to incur new obligations during the course of the fiscal year from baseline funds, putting a repayment amount in the budget act is more problematic for GS \$Mart loans than for other types of repayments.

Large, unscheduled baseline-funded financings should be reported to the Legislature — The Legislature should be informed about financing in all augmentation requests, but the Legislature may not need or desire to be informed about small financings from within baseline budgets that occur during the course of the fiscal year and were previously unanticipated, or large financings that were anticipated and reported in the supplementary schedule of loan repayments. The Department of Finance should establish thresholds for reporting new, previously unreported financings to the Legislature, based on the size of departments' budgets (similar to the thresholds for submitting feasibility study reports [FSR] for IT projects).

Finance staff need appropriate training — Finance staff must be trained to understand that GS \$Mart loans are fixed obligations that must be repaid, and to view such requests in terms of future funding availability, to the extent that can be known. If financings are proposed from special funds, the fund condition should be projected for the term of the loan under alternative assumptions to determine if the repayments can be made.

Finance should establish a centralized resource unit for lease purchasing issues — Finance should establish a unit within the department to be responsible for coordinating with STO and DGS on programmatic and policy issues, and for assuring that program procedures are appropriate and interest rates are competitive. The centralized resource unit would be responsible for training and assisting the programmatic budget staff in understanding how lease-purchasing can affect the State's credit rating, and how to analyze and evaluate financing requests. Decisions on individual requests for financing would be made by the programmatic budget units.

Risky and inappropriate assets should not be financed

Tax-exempt lease-purchasing has developed based on the premise that the financed assets are tangible personal property, which can be repossessed in the event of nonappropriation or default. Also, in theory, should a drastic change in a State program occur such that the assets were no longer essential, the assets could be sold to pay off the loan.²⁶ (However, there could be market implications from selling what were previously deemed “essential” assets.) While such changes are not envisioned when loans are incurred, the current State fiscal situation could result in severe reductions in programs or the elimination of departments that affect loan repayments.

The GS \$Mart program has included several loans that were not for tangible personal property, as described further below. One argument for continuing to finance such loans is that the lenders are agreeable, and have taken the additional risks, if any, into account in the interest rate. While this argument has merit, it leaves the State without any clear guidelines and puts the lender in charge of determining how much risk the State should bear. A more conservative approach is to ensure the highest quality and safest loans by prohibiting the financing of these types of assets. Since there have been very few of these types of loans, there should not be a significant impact on departments. However, an exception process may need to be developed for central service agencies, such as the data centers, which may be unable to accumulate sufficient funds to purchase the assets due to federal restrictions on working capital balances.

System integration projects — The GS \$Mart program has financed five clearly identifiable system integration projects. These projects include hardware, software, and software development (which is a service). It is our understanding that these projects are complex and risky, because there is a high rate of failure and non-completion. These projects usually have multiple deliverables, which are supposed to be structured so that each one by itself has value even if the rest of the project were not completed; however, there is no guarantee that such structuring is possible. Although the GS \$Mart program reduces the risk to the State by requiring payment only for deliverables that have been accepted, it does not make sense to continue lease-

²⁶ The participating department would be required to provide 45 days written notice to the lender that it is prepaying the loan. No other notice or authorization would be required.

purchase payments on a project that has been cancelled, especially if the accepted deliverable has no independent value. Because of this risk, system integration projects may not be good candidates for financing.

Software — The GS \$Mart program has financed 14 loans for software with a total dollar amount \$74 million (or \$22 million excluding the Oracle contract, which was rescinded). Software is not a good, nor is it an asset in that it is not owned by the State agency; ownership remains with the supplier, who provides the State agency with a license to use it. Financing software was described by one lender as “financing air.” Some lenders do not finance software, and some states do not allow financing for software. A conservative approach would be to eliminate such loans from the program.

Real property projects — The GS \$Mart program has financed three real property projects — two for cabling within buildings and one for lighting. Neither type of project provides personal property assets that provide security to the lender. A conservative approach would be to eliminate GS \$Mart financings of real property projects.

Financial reporting must be improved

The State Treasurer relies on the California Annual Financial Report (CAFR), which is prepared by the State Controller’s Office, for financial disclosure on State debt issuance. The CAFR includes information on the dollar volumes of capital lease obligations (in Tables 12 and 15). GS \$Mart loans are capital leases, and the DGS must provide information to the State Controller. The DGS is required to report the same financial information on leases to the Bureau of State Audits. Due to miscommunication between the State Controller’s Office and DGS, the DGS has not been reporting this information, but plans to do so now, for incorporation into the 2002 report. However, it is questionable whether DGS has sufficient information to report properly. The State Controller’s Office needs the DGS to report only on loans with certain fund sources. Proprietary funds use full accrual accounting systems and already report their capital leases to the State Controller’s Office in their annual year-end reports.²⁷ Governmental funds use a modified accrual accounting method and do not report their capital leases. However, the GS \$Mart program does not collect fund source information. Further, the DGS may not be informed of all capital leases, since some departments are exempt from DGS jurisdiction, and some departments use vendor financing without reporting it to DGS. The DGS needs to collect fund source as a routine data item on GS \$Mart loans. Loans outside the program will be discussed further in the section on Legal Framework, below.

²⁷ Departments utilizing proprietary funds include the two major data centers, which are the heaviest users of the GS \$Mart program, and the Department of General Services, which is also a significant user. Thus, a good portion of the GS \$Mart loans have been reported.

B. Legal Framework

Statutory authorization needed, with clear structure and guidance

The authority of State departments to enter into financing contracts for personal property is implied, but it is not explicit or coherent. The GS \$Mart program would be strengthened by legislation that expressly permits State departments to finance tangible personal property. The legislation should indicate that the goals of the program are to assure access of State departments to high-quality loans while protecting the State's credit rating and maximizing budgetary flexibility. The statute should address the issues of competition, accountability, oversight, and protection of the State's interests as are discussed in other sections of this report. The legislation should clearly specify what the State departments can and cannot do. Both financing and re-financing should be explicitly authorized.

Respective roles of DGS, Finance, and the State Treasurer should be clarified

As discussed earlier, there appears to be some ambiguity in the current role of the State Treasurer with respect to personal property financing. The Legislature should authorize the State Treasurer to engage in personal property leasing and give the Treasurer the responsibility to determine which loans should be denied, processed through the DGS, or processed through the STO. Loans processed through the DGS would follow the procedures for the GS \$Mart program. The STO would determine the process to be followed for loans processed under its auspices.

The STO, together with Finance, should provide oversight to the GS \$Mart program operated by the DGS. The STO and Finance are knowledgeable about financing and budgetary issues, and can provide policy and technical advice and guidance about program processes (e.g., contract provisions, form content, etc.) In the DGS, there appear to be no personnel outside the GS \$Mart program that understand financing issues, and program staff do not appear to be sufficiently experienced in the budget process to apply a budgetary perspective to the program. STO and Finance should receive periodic reports so that they can monitor the program, and any changes to the program should be approved by the STO and Finance.

In the course of conducting interviews for this study, there was some discussion about whether the program should be transferred in its entirety to the State Treasurer. Such transfer does not appear to be necessary, since the vast majority the loans are straightforward equipment purchases for relatively small amounts and do not require rigorous scrutiny. Concern was expressed about retaining the efficiencies of the GS \$Mart program for low-risk loans. In addition, small, privately placed municipal leases may not fit well with the State Treasurer's Office primary focus, which is publicly issued debt, since there are different industries and stakeholders involved.

Loans outside the GS \$Mart program put the State at risk and should be prohibited

Departments that borrow outside the GS \$Mart program put the State at risk without the benefit of the expertise and oversight that the GS \$Mart program provides. DGS' legal staff indicated that only a few departmental attorneys have expertise in contract law; it is unlikely that any have expertise in tax and securities law. GS \$Mart staff reported that they were aware of a loan by the Legislative Counsel Bureau that, due to its nature, should have been reviewed by bond counsel to ensure that the requirements for tax-exemption were met; however, there was no bond counsel review. When the IRS determines that a loan sold as tax-exempt fails to meet the tax-exemption requirements, it can require the lenders to re-file their taxes. The lenders might also have legal recourse against the issuer.

Other risks of departments borrowing outside the GS \$Mart program are that their contracts might not sufficiently protect the State's interests or interest rates might be excessive. Absent centralized oversight, the State lacks a good assessment of the actual risks involved.

Of the seven loans in the data set that were outside the GS \$Mart program, five of these were for the Department of Justice, including two that occurred in May 1996 when the GS \$Mart program first started. One was for the Public Employees' Retirement System (PERS), which is exempt from the DGS' procurement rules. One project was for the Department of Motor Vehicles, and it was refinanced by a GS \$Mart loan at a significantly lower interest rate. The Legislative Counsel Bureau loan was not included.

Legislation should be enacted requiring all State departments that engage in financing contracts to utilize the STO/GS \$Mart program. Entities that have their own credit ratings would be exempted, because if they defaulted on a loan it would not affect the State's credit

rating. These entities are the University of California, California State University, Department of Water Resources, Public Works Board, California Housing Finance Authority, California Infrastructure and Economic Development Bank, California Power Authority, State Water Resources Control Board, and the conduit agencies operating under the auspices of the State Treasurer's Office. The Legislative Data Center does not have its own credit rating and should not be exempt. PERS has used the GS \$Mart program once already, but PERS and the State Teachers' Retirement System (STRS) cannot be mandated to use a centralized process due to their constitutional autonomy. If either PERS or STRS wishes to undertake lease-purchasing outside of the GS \$Mart program, it should establish a policy through a board item, which would give the State Treasurer, who sits on both boards, an opportunity to raise the appropriate issues.

Two existing statutory provisions should be deleted

Two provisions of existing law that affect the GS \$Mart program are inconsistent with sound principles for tax-exempt lease-purchasing and should be deleted:

Bids for acquisition and financing should be fully separated. The GS \$Mart program achieves its competitive advantage by soliciting financing bids separately from the acquisition. This advantage is undermined by Public Contract Code Section 12102(e), which requires that supplier-provided financing proposals be considered at least 30 days before the final bid date. This special allowance for supplier proposals provides an incentive for the supplier to inflate the price of the good in order to reduce the price of the financing, particularly on non-competitive bids. The potential for such pricing distortions does not serve the best interests of the State. This statutory provision should be repealed, and a new provision should be adopted which clearly states that bids from suppliers and lenders will be processed separately.

Telecommunications services should not be financed. In the early years of the GS \$Mart, some of the loans for telephone equipment included prepaid telephone services. Although the GS \$Mart program generally does not allow the financing of services, some suppliers at that time were offering lower telephone bills to customers who paid in advance, and lenders were willing to finance such arrangements. Public Contract Code Section 12113 specifically authorizes such financings. Although prepaid services have not been financed recently, it could happen again. Services are not a tangible asset, and not a prudent basis for a tax-exempt lease. As a practical matter, if a department with such a lease were eliminated or severely downsized, the State would be obligated to pay for services it no longer needed.

Nonsubstitution clause should be eliminated

As discussed earlier, the nonsubstitution clause in the Alpha Plan penalizes the State for nonappropriation of lease-purchase repayments by prohibiting the State from replacing the assets for one year. The validity of the nonsubstitution clause — which is not a statutory provision — is questionable, and may even impair the legal position that a GS \$Mart loan is not constitutional debt.

Some courts have frowned on the nonsubstitution clause, because it infringes on the right of the Legislature to appropriate funds. The clause has not been tested in California, but in 2000, the Supreme Court of Florida ruled (and the US Court of Appeals affirmed) that the nonsubstitution clause was void and unenforceable.²⁸ The Florida Supreme Court stated that the nonsubstitution clause rendered “illusory” both the nonappropriation clause and the disclaimer that tax revenues would not be used to repay the loan. Thus, the court deemed that the nonsubstitution clause transformed the lease into a debt, in violation of the Florida constitution. In Louisiana, the attorney general opined in 1986 that the nonsubstitution clause compels lease payments and creates debt, and in Texas, the attorney general will not approve a lease-purchase contract with a nonsubstitution clause. In addition, the Florida court stated that the nonsubstitution clause was void because it was contrary to public policy in that the consequences would have been disastrous — in the case before the court, the county’s inability to replace the asset, which was a centralized computer system for all county operations, would have shut down the county.

Many bond lawyers think the nonsubstitution clause should be eliminated, because its presence in a contract could invalidate the entire contract.²⁹ The Alpha Plan is potentially at risk of invalidation because the nonsubstitution period is long (a full year), the qualifying language is weak (i.e., the clause is to operate “to the extent permitted by law,” stronger language would be “to the extent that the validity of this lease will not be adversely affected”), and there is no severability clause to specify that if any provision is found invalid by a court, the rest of the contract is not affected. There was a severability clause in the Florida lease, and the court found that the nonsubstitution clause was severable because it did not go to the essence of the contract. However, some lawyers consider the severability clause a weak protection.

²⁸ Supreme Court of Florida, No. SC96384, *Frankenmuth Mutual Insurance Company etc. v. Ernie Lee Magaha, etc., et al.*, September 21, 2000. United States Court of Appeals for the 11th Circuit, Opinion No. 01-12976, *Frankenmuth Mutual Insurance Company v. Escambia County, Florida*, dated April 24, 2002.

²⁹ Interview with Jay D. Terry, attorney at law of Leonard Frost Levin and Van Court (Dallas, Texas), October 8, 2002.

Although the purpose of the nonsubstitution clause is to protect the lender, the lender would be at risk if the contract were invalidated by the courts because of the nonsubstitution clause. For this reason, some lenders do not favor the nonsubstitution clause. Koch, one of the biggest participants in the GS \$Mart program, uses the nonsubstitution clause in GS \$Mart because it is required as part of the standard contract, but Koch does not use the nonsubstitution clause in its other leasing programs.

Other lenders do favor the nonsubstitution clause, and see it as an additional lender protection. These lenders would probably try to raise the rates charged to the GS \$Mart program. However, Koch has stated that it would not raise its rates, and since Koch's rates are already among the lowest, Koch would function as a damper on other lenders' rates. In addition, other changes recommended in this report (i.e., budgetary approval [discussed above] and better documentation of essential need [discussed below]) would increase lender assurance and help offset concerns about elimination of the nonsubstitution clause.

C. Due Diligence

The GS \$Mart program should be amended to include due diligence procedures that will assure high-quality loans, in order to minimize the possibility that the Legislature will not appropriate the repayment funds. There are five aspects of due diligence which ensure that the loan is of high quality and a "good deal": (1) the asset be necessary; (2) the procurement must be cost-effective; (3) the procurement must be properly executed within the law and regulations; (4) the financing arrangement must be cost-effective; and (5) the loan process and contract must protect the State's interests. The program's performance and needed corrective measures vary with respect to these five aspects, as described below:

1. **Necessity of asset** — If the recommendations in this report for budgetary approval are adopted, the necessity for the assets to be financed will be vetted by Finance and, in many cases, the Legislature. The DGS' role in the GS \$Mart program is to ensure that the need is fully documented, rather than judge a department's stated needs.
2. **Cost-effectiveness of the procurement** — The cost-effectiveness of the procurement is dependent upon the competitiveness of the bidding process. The procurement reforms recommended by the Governor's Contracting and Procurement Task Force are designed to help ensure that procurements are competitive and of high quality. The DGS' role through the Procurement Division is to ensure that departments comply with competitive bidding requirements.

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3. **Proper execution of the procurement** — Publications describing the GS \$Mart program offer contradictory views on the program's responsibility to verify the propriety of the procurement process. CAM 3.1.6 states that it is "not the GS \$Mart manager's responsibility to police the actual procurement." On the other hand, the program's newsletter, \$Mart News, stated in the October 2000 issue that "it is our mission to make sure the procurement was done correctly," and further stated that "*every aspect* of a procurement that has financing or leasing attached is reviewed by OLS [Office of Legal Services]." In practice, there has been little review of the procurement process by GS \$Mart or OLS. The DGS' role through the Procurement Division is to ensure that departments comply with procurement laws and regulations. The DGS' role through the OLS is to validate that procurements for GS \$Mart loans were properly executed.
 4. **Cost-effectiveness of financing** — The quality of the financing deal — i.e., the interest rate — has been the primary concern of the GS \$Mart program. The program appears to have performed this function well. The program attracts a significant number of lenders and the rates are competitive. Rates are updated frequently and reflect the current market. The GS \$Mart staff try to keep a tight rein on the lenders by verifying that the rates are all-inclusive, by not allowing them to raise their rates on "plain vanilla" deals, by comparing the rates lenders charge the State with what they charge local agencies, and by comparing the rates in the GS \$Mart program to rates in other states.
 5. **Loan process and contract protect the State's interests** — The program's emphasis on customer service has not been sufficiently balanced by protection of the State's interests through oversight and accountability. The DGS' role in the GS \$Mart program is to adopt loan procedures and contract language to protect the State's interests. To its credit, the DGS has recognized this situation and in recent months has begun to institute changes.

The recommendations below address procedural changes in the areas of procurement, loan processing, contract content, and OLS review that will improve oversight and accountability and promote due diligence in the GS \$Mart program.

Procurement Concerns

Procurement authority needs better documentation — Although the DGS verifies the State department's delegated authority, there is no formal requirement for the State department to document other authority for the procurement, such as approval letters from the Department of Finance's Technology Investment Review Unit. If the DGS is procuring a large IT project, the Procurement Division will have on file copies of the FSR approval letters, which the GS \$Mart program may review. The DGS has stated that the revised Certificate of Compliance will require documentation of authority, a change we recommend.

Evidence of proper bidding needs documentation — The Certificate of Compliance requires the State department to indicate if the procurement was based on a CMAS, master agreement, competitive bid, or non-competitive bid. We are advised that the revised form will require documentation of the bid process to demonstrate that the rules were followed. We recommend this change as well.

Loan Process Concerns

Fund source needs to be taken into account — Assets purchased with federal funds are not eligible for financing under the Alpha Plan if the assets are to be the property of the federal government, or if the federal government has specified that no interest can be paid. (These assets could be financed under the Beta Plan.) The GS \$Mart program has not routinely asked departments if their procurements were funded with federal funds; it only asked selected departments, based on the GS \$Mart manager's judgment, if federal funds were the source for the asset purchase. However, GS \$Mart staff are not sufficiently knowledgeable about the budgets of all the departments using the GS \$Mart program to judge when to question the funding source. As noted above, the GS \$Mart program manager advises that the program is going to have to start tracking fund source information for annual reporting to the State Controller, so this problem should correct itself. We recommend that the program manager advise Finance when this reporting has been put into place.

Essential need for asset needs better documentation — As discussed in Section II, establishing that the asset is an essential need is a standard requirement in a municipal lease, because it assures the lender that the Legislature will appropriate the funds for the department to repay the loan, and thus helps insure a lower interest rate. The

GS \$Mart program used to have an entire form for documenting essential need, but this form is no longer in use. The Rate Quote form provides two lines to explain the reason for the acquisition to the prospective lenders, but on an example provided by GS \$Mart staff (and prepared by them) that section was not completed. Lenders have the option of asking for additional information. The Alpha Plan Certification form includes a printed statement in which the State department certifies that the assets are essential to its performance and the need is not temporary. Two lines are provided for the department to describe the purposes of the assets, however this form is completed at the end of the process after the lender and interest rate have been determined.

In our interviews with lenders, they indicated that they would like more specific written documentation of need. Koch uses its own essential need certificate in other states. The Koch form provides three lines for the department to describe the use of the equipment, and asks for information on: (1) whether the equipment is new, an upgrade, additional, or a replacement; (2) the age of any equipment being replaced; (3) how new computer hardware and software relates to existing hardware. From a budgetary perspective, both the GS \$Mart document and the Koch form are inadequate. Adoption of a Department of Finance approval form that includes full justification of need, as recommended above, should also meet the need of the lenders for better documentation of essentiality.

Program should follow its own rules — There have been several instances in which the GS \$Mart program did not follow the rules it established for the program. Three real property projects were funded, despite the rule that the assets must be personal property, and not building improvements. A five-year loan for personal computers was allowed, despite the rule that the term of the loan cannot exceed the useful life of the equipment, and a three-year useful life was applied to all other personal computer loans. For the Oracle contract, the program allowed a non-qualified lender to participate in the program, and amended the standard contract (i.e., by eliminating the prepayment penalty) that all participants are required to use. The GS \$Mart program put the State at risk when it violated its own rules. Such lapses must not be repeated.

Lenders should be evaluated — Until recently, departments were able to select the lenders from whom they solicited rate quotes. Some departments did not request quotes from certain lenders if they had a previous unsatisfactory experience with the lender, or if they heard of such experiences from other departments. Unsatisfactory experiences include tardiness in completion of closing documents, tardiness or inaccuracies in billing,

and unpleasantness in personal communications. Departments did not routinely report these problems to the GS \$Mart program, and the GS \$Mart program did not solicit departments' opinions. Evaluation of lenders is especially important now that the GS \$Mart program is selecting the lenders for the rate quotes. The DGS should conduct an annual lender evaluation survey of user departments to ensure that problems are resolved and that departments are getting high-quality service.

Lowest cost lender should be required for all asset types — As noted in Section VI, the DGS has tried to align the financing criteria with the asset procurement criteria by requiring departments to select the lender with the lowest financing cost on non-IT goods, but allowing them to select the lender providing “best value” for IT goods and services. The CAM section explaining “best value” in the GS \$Mart program has not yet been written. When asked to define “best value” in financing, GS \$Mart staff provided a definition of best value in IT asset procurements, which was not relevant. The GS \$Mart program should require departments to select the lowest cost lender regardless of asset type, unless there is a compelling reason, which should then be documented. GS \$Mart staff have indicated that they are in the process of instituting this change, and will be requiring departments to provide written justification when they do not choose the lowest cost lender.

It should be noted that in interviews with departments, most indicated that quality of service was very important to them, but only one department indicated that it occasionally chose the lender based on quality of service instead of lowest cost. However, GS \$Mart staff indicated that another one of the departments interviewed tended to choose a lender with whom it had a longstanding relationship.

Treatment of small business lenders should be clarified — The treatment of small business lenders is another area in which the DGS would like to align the financing criteria with the asset procurement criteria. Government Code Section 14838.5 *allows* IT and non-IT goods and services costing less than \$100,000 to be procured based on two bids from small businesses or disabled veteran business enterprises. Currently there is only one certified small business among the qualified lenders. When the GS \$Mart program requests quotes from the five lowest lenders, it also requests a quote from the small lender (if it is not already among the five lowest), and gives a 5 percent preference on the cost of the financing.

According to GS \$Mart staff, if there were another small lender qualified in the program and the assets being financed cost less than \$100,000, the GS \$Mart staff would not solicit bids from the five lowest lenders but only from the two small businesses. Based on the historical data, about 15 percent of GS \$Mart loans were under \$100,000. However, the program only recommended a minimum value as low as \$50,000 less than two years ago (the former minimum was \$100,000), so the proportion may increase in the future. All of these small loans would be *required* to use a process that results in less competitive rates. If Government Code Section 14838.5 were applied to the cost of the financing itself — i.e., the interest costs — as a service, then the section would apply to assets costing from up to \$1 million to \$3 million (depending on the length of the financing term), because only at that asset cost does the cost of the interest approximate \$100,000. The DGS should obtain legislative clarification of how to apply Government Code Section 14838.5 to personal property financing.

Training and certification of departmental personnel should be instituted — The GS \$Mart program appears to make a significant effort to educate departmental staff about the program’s risks and rules before allowing the department to participate in the program. All of the individuals in the ten departments interviewed for this study had a clear understanding that their failure to repay a GS \$Mart loan put the State credit rating at risk. However, the staff of one department that heavily utilizes the program indicated that they were not aware of the fact that there was no termination for convenience in the GS \$Mart program, which is a serious misunderstanding. No implication is being made that the DGS did not provide sufficient information to some persons in this department. However, given the consequences of failure to make a scheduled payment, it is essential that individuals that participate in this program properly understand it. The Governor’s Task Force on Contracting and Procurement Review recommended that the DGS institute a program to train and certify State departmental personnel in the various aspects of the procurement process, and that only properly certified individuals be allowed to engage in specific procurement activities.³⁰ We recommend that the DGS require training and certification in the GS \$Mart program before individuals within departments are allowed to participate in the program.

Alpha Plan Certification Form should be signed by the lender — The Alpha Plan Certification Form binds the State and the lender to certain requirements. However, only the State agency signs the certification form. The DGS should also require the lender to sign the certification form.

³⁰ Governor’s Task Force on Contract and Procurement Review, *Final Report*, August 30, 2002, page 26, Recommendation #8.

Contract Concerns

Alpha Plan contract should be signed — A printed copy of the Alpha Plan is not a part of the loan package. The Alpha Plan is typically “incorporated by reference” into the purchase order for the goods, including notation of the then-current version of the contract. According to the website, a lender’s bid on a financing proposal constitutes an agreement to the terms and conditions of the Alpha Plan.³¹ Since the contract has undergone revisions at times, the version on the Internet at any given time may not be the contract that was in effect when the loan was finalized. Some departments maintain a hard copy of the relevant Alpha Plan in the file for each loan, and copies are available from the DGS. However, since the Alpha Plan is a contract with prescribed covenants for the State, the lender, and the assignees, the DGS should ensure that a printed copy is signed by all parties.

Clarification of “lender” needed — The first paragraph of the Alpha Plan defines the lender as “the provider of the financing,” a definition that can create problems. In the Oracle case, the supplier contract (i.e., for purchasing the software) designated Logicon as the lender and Koch as the assignee. However, since Koch was providing the financing, Koch was considered the lender for purposes of the Alpha Plan. Thus, this sentence created a conflict between the two contracts. It is not known if this conflict exists between other contracts. In addition, since the original lender can remain the paying agent even if the assignee is providing the financing, the sentence creates confusion within the Alpha Plan itself regarding which entity is the “lender.” The DGS should eliminate this sentence.

Administrative cost language should be updated — The Alpha Plan indicates that the State will not receive any funds from the financing arrangement, except for fees to reimburse the DGS for its costs of the financing contract. This provision refers to a prior practice of charging State departments \$2,000 for each GS \$Mart loan to cover GS \$Mart administrative costs. Because the program is now funded from the general procurement fee (currently 1.93 percent of the total procurement), this language should be updated to be consistent with current practice.

State benefits from escrow account should be in contract — As noted earlier, when a loan involves multiple payments to the supplier, the lender sets aside the entire loan amount in an escrow account (also known as an acquisition fund). The lender earns interest on the account, which is subject to federal arbitrage rebate rules. Certain

³¹ See section on Lender Qualifications, under the heading Qualifications Proposal.

earnings on the account can be used to pay the supplier, which then reduces the amount that needs to be financed. The program is administered in a manner that applies these earnings to the benefit of the State, but the DGS should ensure that this mechanism is explicit in the contract.

Legal Oversight and Review Needs Strengthening

The GS \$Mart staff assert that contracts are reviewed for appropriateness and consistency, but in practice, there is little review. There are two opportunities for this review. First, the GS \$Mart manager can assess appropriateness and consistency before the completed package is sent to the OLS for the Opinion of Counsel (if the Opinion is required by the lender). Second, OLS can make the same assessment at the very end of the process. The OLS counsel assigned to the GS \$Mart program indicated that she reviews the purchase order, the Certificate of Compliance, the payment schedule and other documents, such as any supplemental terms and conditions, to see if the documentation is complete and if dates and references are consistent. The OLS counsel does not review the Alpha Plan, or the entire CMAS contract. If the GS \$Mart loan is for a re-financing, the OLS counsel does not receive the original documentation.

Changes to standard contracts should be identified for review — Most departments use standard DGS contracts for their procurements and the standard Alpha Plan for the financing. Most departments interviewed indicated that they rarely if ever made amendments, but if they did, they would have them approved by the DGS. To the extent that departments provide a purchase order as the contract, any special terms and conditions would be attached as an addendum, and would be quite visible. To the extent that the GS \$Mart manager is informed of changes, the manager reviews them and refers any questions to OLS. *However, it is possible for departments to amend the standard contracts without the DGS being aware of it.* The DGS should institute a process that requires departments to inform it whether any changes were made to standard contracts so that the DGS can review them. The Governor's Task Force on Contracting and Procurement Review recommended that the DGS ensure active legal participation in all high-risk contracts, including any that deviate from the standard terms and conditions.³² OLS staff indicated in interviews that they will be working more closely with the Procurement Division in the future.

³² Governor's Task Force on Contract and Procurement Review, *Final Report*, August 30, 2002, page 26, Recommendation #15.

Consistency between procurement and financing contract/closing documents should be rigorously checked — The DGS has asserted that there is no inconsistency between standardized contracts for procurement and the Alpha Plan. However, inconsistencies can occur when changes are made. As noted earlier, the Oracle procurement contract designated Logicon as the lender, but in the financing contract Koch was deemed to be the lender. In a Department of Justice procurement contract, there was a phased implementation, and the Department of Justice added performance requirements for the supplier to meet over the course of the contract. The standard language in the Certification Form indicates that the assets have been accepted (i.e., that the performance requirements have already been met.) The Department of Justice pointed out to the DGS that this language needed to be amended.

Opinion of Counsel should be required on all contracts — The Opinion of Counsel is only provided if requested by the lender. Since all but one of the lenders require it, the opinion is provided for almost all loans. However, the opinion should be required on all loans, so that the State is assured that all the contracts are valid, legal, and binding.

Opinion of Counsel should be stronger — The form letter for the Opinion of Counsel provides a very weak assurance of the contract's validity, because it is based almost entirely on the assertions of the State department in the Certificate of Compliance, instead of on the OLS counsel's review of original documents as is standard in opinion of counsel documents. An opinion of counsel typically states, "I have examined ... documents, public records and other instruments and have conducted such other investigations of fact and law as I deemed necessary ... " In contrast, the GS \$Mart opinion states merely, "I acknowledge that all necessary proceedings ... have taken place ... " OLS will be conducting more review of original documents due to the documentation the GS \$Mart program will be requiring for the Certificate of Compliance, as well as the new involvement of OLS staff in high-risk contracts as recommended by the Governor's Task Force on Contracting and Procurement Reform. However, OLS should strengthen its requirements so that it can review all the original documents necessary to arrive at an original opinion. If such review is not feasible, every effort should be made to minimize the reliance on departmental certifications. The standard opinion document should be revised accordingly.

SECTION EIGHT

Conclusion

The GS \$Mart program has provided a necessary means for State agencies to purchase essential equipment over multiple fiscal years. The program has been successful in providing State departments and lenders with a competitive, efficient process. However, the program has placed insufficient emphasis on oversight and accountability and has not always adhered strictly to sound principles of municipal lease financing. The State's credit rating has been exposed to potential risk through the financing of large loans in the tens of millions of dollars with insufficient due diligence processes. Additional risks are posed by those departments that undertake loans outside the GS \$Mart program, and thus without any expertise or oversight in this highly complex area.

This report makes several recommendations that involve policy decisions and the participation of multiple entities:

- Giving the STO responsibility to determine which loans pose higher risks and to process those loans itself.
- Restricting the types of loans.
- Determining how to prohibit or restrict loans outside the program.
- Enactment of enabling legislation.
- Incorporation into the budgetary process.

The report makes other recommendations that can be implemented by the DGS:

- Changes to the procurement, loan, and legal review processes.
- Contract changes.
- Fund source data collection and reporting to the State Controller's Office and Bureau of State Audits.

Adoption of these recommendations would not only reduce the risks to the State, but also help reassure lenders about the State's willingness to repay the loans. On the other hand, there will be more notification requirements for lenders with regard to assignment, securitization, and placement. There would be more workload for departments to gain budgetary approval for financing and to provide appropriate documentation to the STO and DGS, and more workload for the DGS, STO, Finance, and the Legislature to approve the financings.

It is difficult to predict if there would be any effect on lender participation or the interest rates lenders would charge. The additional reassurances should serve to reduce interest rates, but the additional notification requirements might increase them. A critical factor is whether the time between the rate quote and finalization of the loan would be increased, because any increase would cause lenders to raise their rates to better protect themselves from the risk of market changes. For low-risk loans processed through the DGS, the only recommendations that could increase the time between the rate quote and the finalization are those involving increased legal oversight. If a department submits all the proper documentation, any increase in time could be minimal. Higher risk loans under the State Treasurer's Office would receive additional scrutiny, particularly if the State Treasurer decides it is appropriate to place the lease-secured loan in the public market. The time involved for these loans would be dependent upon the process determined by the State Treasurer's Office. On the other hand, the additional scrutiny should serve to additionally reassure lenders, which might result in lower interest rates.

APPENDIX

Programs in Other States

Massachusetts, New York, and Virginia have significant programs that are similar to the GS \$Mart program. Description of these programs is not intended to provide a representative sample of programs nationwide, but rather some perspective on issues relevant to the GS \$Mart program. Each of these states has tried to protect its credit rating by incorporating restrictions on its program that are absent from the GS \$Mart program. While not every program has every restriction, the restrictions include: limitation on type of assets that may be financed, limitations on size of loan, pre-approval by the budgetary authority, inclusion of lease payments in the budget act, restrictions on assignment, and state government approval of contracts outside the program. It must also be noted that these programs have fewer lenders than the GS \$Mart program, and may be paying higher interest rates.

Massachusetts

Massachusetts has operated the Tax-Exempt Lease Purchase (TELP) financing program for five years. The largest individual loans have been about \$15 million. The program typically finances about \$20 million in total loans annually.

There are two TELP programs: an indexed rate program and a competitive rate program. The indexed rate program provides tax-exempt financing for small loans or small departments at a rate indexed to a benchmark. Loans must be a minimum of \$15,000 and there is a single contractor. The competitive rate program operates similarly to the GS \$Mart program, with four qualified lenders who bid on individual loans. The loans must be for a minimum of \$50,000. Departments are also allowed to use vendor-provided financing, although they are strongly urged to get competitive bids from TELP. For all three types of financings, departments must use the same standard State contract, due to the complexities of lease-purchase financing and the risk to the State's credit rating.

There is no cap on the loan amount, but risk to the State's credit rating is limited by allowing TELP loans to be used only for equipment and by prohibiting TELP loans for capital expenditures. Departments are not allowed to finance software. Departments are also not allowed to undertake loans that require the use of escrow accounts.

The program emphasizes to departments that loans must be repaid, even if other contract obligations must be decreased or employees laid off. Departments are required to obtain prior approval from the budget authority, which must complete the authorization form within five days. On the budget authorization form, the budget official indicates whether or not the financing can be funded in the current fiscal year, whether or not the financing appears supportable in subsequent fiscal years, and whether or not the financing appears to circumvent controls on capital expenditures.

Departments must select the lender that provides the best value to the State. If the selected lender was not the lowest bidder, the State will make the reason for the selection public. The State has established performance measurements for lenders, and conducts an annual lender evaluation survey of user departments.

Loans may be assigned, but must be placed privately. (Public offerings [bonds] are used only for capital outlay.) The original lender must continue to carry out all obligations and responsibilities under the contract.

New York

New York's lease purchase program was developed when the State decided that, due to budgetary constraints, it would no longer utilize certificates of participation (COPs) to finance State agency equipment purchases. The program has been in existence for two years, and finances about 100 loans annually.

The statewide contract indicates that it does not anticipate that the lender will assign the loan, or transfer it in such a way that interests in it would be held by more than one party. Issuance of COPs or similar instruments is prohibited. Assignment is allowed, but must be approved by the State. State officials indicated that most lenders do not assign the loans. In an interview with Koch, one of New York's contractors, Koch indicated that the restrictions on assignment and securitization resulted in limited lender interest and higher interest rates. There are four lenders in the New York program.

The program is designed primarily for equipment, but may be used for software and system integration projects. IT projects with services included must have a minimum of \$250,000 of hardware and software. Escrow accounts are allowed. Departments are allowed to pay the supplier before acceptance if the supplier provides a performance bond.

Departments must receive approval by the budget division before being allowed to enter into a lease-purchase agreement. As part of the annual budget preparation process, departments must submit a schedule of installment payments for all new and outstanding lease purchases.

Individual loans must be for a minimum of \$250,000 and a maximum of \$15 million; loans are for a maximum of three years unless approved for a longer period by the budget division. Departments must select the lowest cost lender.

Virginia

Virginia's program has operated since 1987. It is authorized by statute and administered by the Department of Treasury.³³ The statute requires the Department of Treasury to review and approve the financial terms of all contracts for personal property acquisitions involving installment financing. Personal property is defined by the Department of Treasury as including tangible personal property, including personal property to be affixed to realty. The program funded about 23 loans in the last year, ranging in size from \$10,000 to about \$12 million.

Each year, the Department of Treasury puts out to bid and contracts for a \$30 million line of credit. There are two contracts, each of which is awarded to one contractor (the same contractor could be awarded both contracts): one for loans of 3, 4, and 5 years, and one for loans of 7 years. The bidders offer a bid indexed to one of two benchmarks: either the US Treasury Note Index, or the Municipal Market Data (MMD) General Obligation Yield. The contract may be extended for 6-12 months or for an additional \$15 million. The contractors are allowed to refuse to finance a loan if they determine that the item is non-essential, the useful life is for less than the term of the loan, or the project has too great a risk of non-completion or non-performance.

The program is intended for equipment and energy efficiency projects. Equipment projects are not allowed to include "soft costs," which are defined as installation, shipping and handling, maintenance, consulting, etc.; therefore system integration projects are not allowed. Software as a general rule is not allowed, because it involves a user license and is

³³ The State Treasurer is appointed by the Governor.

not personal property. However, software may be funded in conjunction with hardware if the lender approves. One lender requires that the hardware component be at least 70 percent. Soft costs are allowable for energy efficiency projects, which are considered by definition to include them.

State departments are required to submit a financing request form to the Department of Treasury, which includes information about essential use and is accompanied by project justification documents. The department director or a high-level manager must sign the application. The Department of Treasury is expected to make its determination on the request within a week. The Department of Treasury is specifically concerned about financings for other than personal property, lease terms greater than the useful life, inclusion of software or soft costs, and essential use.

Departments must demonstrate that the funds to repay the loans have already been appropriated in the State's two-year budget. The budget act specifically identifies amounts appropriated for lease purchase repayments. Thus, departments are required to plan their installment purchases in advance, and include proposed amounts for repayment in their biennial budget requests. If a department needs to replace essential equipment unexpectedly, it may still be allowed to utilize the program, but it must demonstrate that it has funds available in its base budget for repayment. In some cases, the department will lease the equipment (i.e., without purchasing it) instead.

Departments are allowed to enter financing agreements outside the State program if their purchase does not meet the program's parameters (e.g., an airplane was financed over a 10-year period, which the program does not offer) or they can obtain a lower interest rate. However, outside financings must be requested from and approved by the Department of Treasury.

The lenders are allowed to assign the master contract or their obligations with written permission. Written permission is not required for a transfer of interests to a trust or partnership held by a limited number of sophisticated investors. The contract states that lenders are not allowed to securitize the contract for a public offering without written permission; a Department of Treasury official indicated that securitization could not be approved because it was not allowed in statute. The lender may assign the interest in an individual loan, but must remain the paying agent and keep records of the assignment in accordance with federal requirements.